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CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1990

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ECONOMICS

JANUARY 18, 1989—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE
FEBRUARY 21, 1989—VIEWS OF THE BUSH ADMINISTRATION
FEBRUARY 22, 1989—VIEWS OF OUTSIDE ECONOMISTS
FEBRUARY 28, 1989—VIEWS OF THE FEDERAL RESERVE SYSTEM
MARCH 1, 1989—VIEWS OF THE SECRETARY OF THE TREASURY

Volume I of III

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VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

WEDNESDAY, JANUARY 18, 1989

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Riegle, Sanford, Conrad, Robb, Domenici, Grassley, Gramm, and Bond.

Staff present: John L. Hilley, staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

Chairman **Sasser**. The committee will come to order.

We are delighted to have back with us the ranking member of the committee, Senator Domenici. Welcome back, Senator.

Senator **Domenici**. Thank you. I missed one day.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman **Sasser**. Well, we missed you yesterday, but we did our best to carry on in your absence.

I want to welcome everyone here this morning and particular welcome Jim Blum and his colleagues from the Congressional Budget Office.

Let me begin this morning our examination of economic assumptions for fiscal year 1990 with what I think is an arresting statistical fact. In the first seven annual deficit forecasts, the current administration has understated the size of the deficit by an average of $33 billion per year.

Now, that is not intended to be a blanket indictment of the Reagan administration because no one accurately predicted the deficit impact of the 1981-82 recession. In fact, nobody saw that recession coming, frankly.

But even as recently as 1988, the administration's highly optimistic economic assumptions enabled them to underestimate the deficit problem by some $35 billion.

Now, I draw attention to these numbers first to point out that economic forecasting is a notoriously risky business, and it appears to be getting risky as the years go on, but second, and perhaps most important, to emphasize the fact that in the Gramm-Rudman-Hollings years, deficit reduction has become a numbers game. You can maximize revenue by presuming a high growth forecast. On the other hand, you can minimize expenditures by assuming low interest rates.

In its 1990 budget, the Reagan administration has pulled a 1993 balanced budget out of the deep deficit hat, and it has done so by assuming that we will grow out of our fiscal problems. According to this view, we will put an end to our deficits without changing in any way the fiscal policies that have tripled the national debt in the space of just 8 years.

The administration is able to do that by estimating short-term interest rates this quarter at about 6.7 percent; whereas, as of this month, 90-day Treasury Bills are currently running at about 8.3 percent, or a difference of about 1.5 percent in interest rates.

The Reagan Office of Management and Budget also predicts sustained real GNP growth of 3.2 percent, although the *Blue Chip* forecast is coming in much lower. Moreover, the administration envisions no conflict between its optimistic interest rate estimates and its optimistic growth estimates—a view that runs counter to most conventional economic thinking.

In light of the general skepticism that has greeted the final Reagan administration budget, the committee has today invited the nonpartisan Congressional Budget Office to present its own economic and deficit projections for 1990 and the succeeding 4 years.

I think we are all aware of the fundamental divergences between the conclusions of OMB and those of CBO. We have got them graphically represented here this morning.

CHART 1

Comparison of OMB and CBO Deficit Projections 1990 - 1994

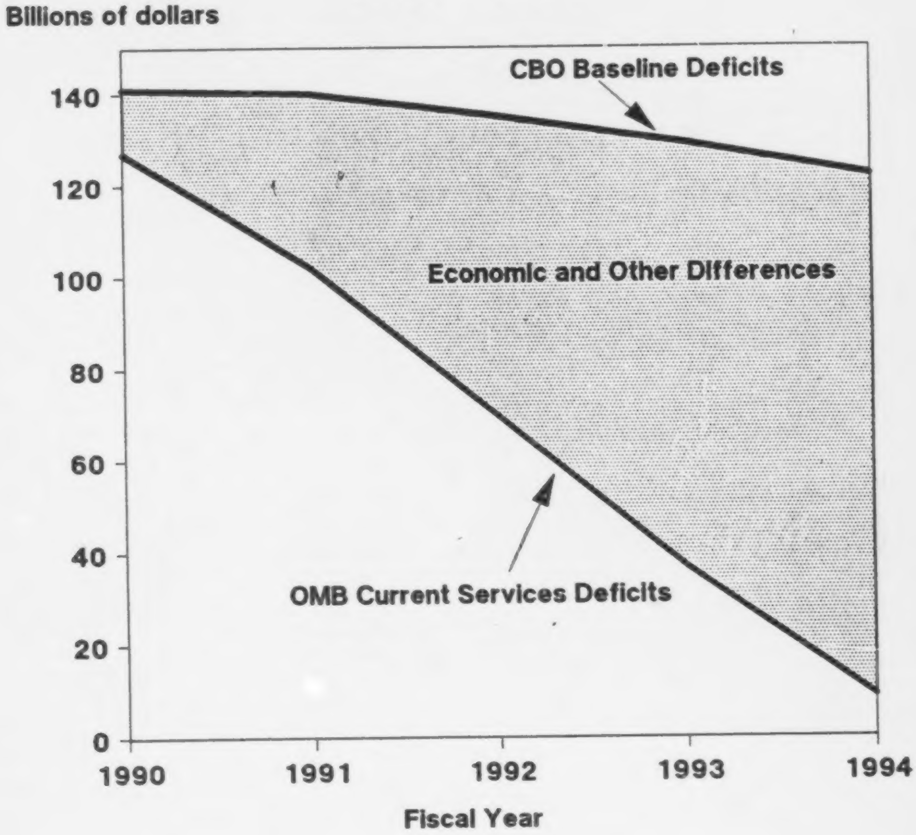


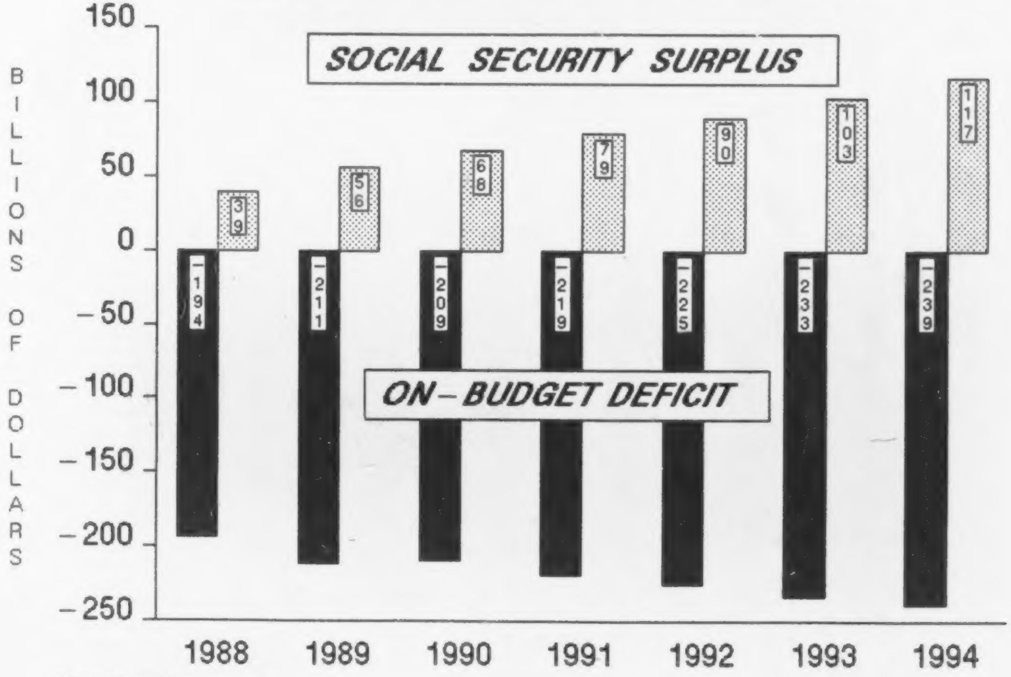
Chart 1 illustrates the point, I think, very clearly. In 1990, CBO projects a deficit of $14 billion more than OMB's estimates. CBO's numbers are the top line on the chart. The gap between OMB and CBO is due mainly, of course, to the difference in economic assumptions. It is $14 billion in fiscal year 1990; but it widens over the next 4 years until 1994.

At that point, when OMB is projecting a budget that is very nearly balanced, without any deficit reduction steps being taken at all, CBO is projecting a $122 billion deficit, all as a result of the differences in economic assumptions.

Chart 2 illustrates the true dimensions of the deficit problem. You can see what happens when we lift the veil of the social security surplus, which is currently included in the unified budget. The result is $200 billion deficits as far as the eye can see.

CHART 2

ON – BUDGET DEFICIT VS. SOCIAL SECURITY SURPLUS

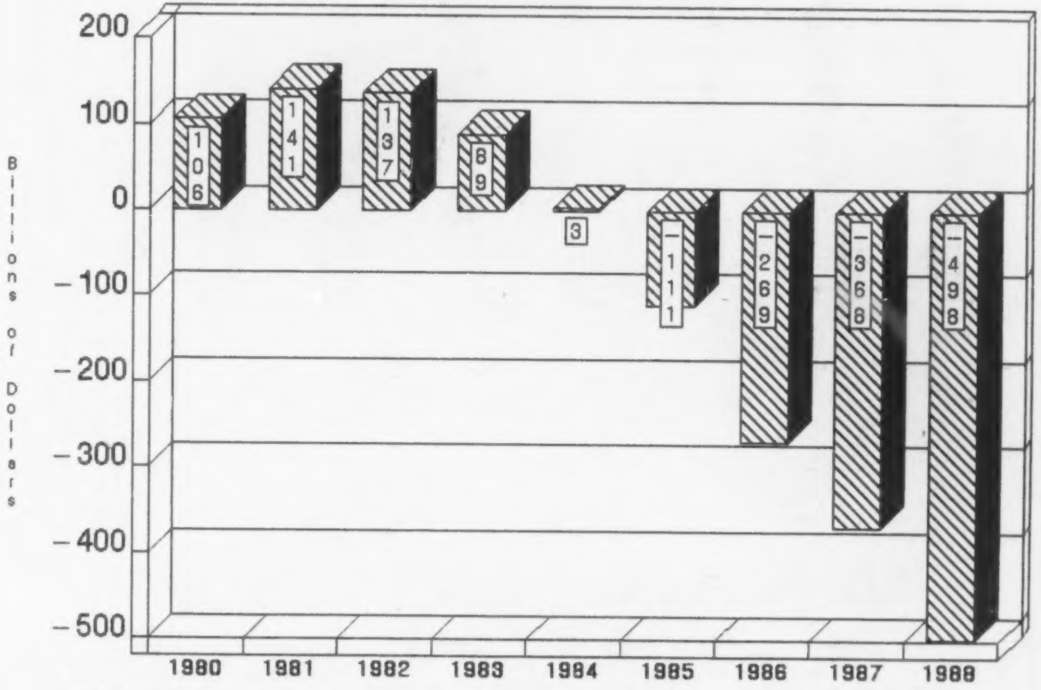


Senate Budget Committee Staff
CBO Estimates – January 1989

CHART 3

US International Debt

From Largest Creditor to Largest Debtor



Source: Economic Report of the President January 1989 Senate Budget Committee Staff

Chart 3 illustrates some of the more threatening consequences, either direct or indirect, of the failed fiscal policy of recent years. As you can see, the United States has moved from being the largest creditor nation in 1980 to the largest debtor nation in the world at the present time—a negative swing of some $600 billion in less than a decade, and a downward spiral that could well spell economic hardship for generations to come.

This downward path, in my judgment, is inevitable only if we refuse to acknowledge the facts, only if we continue to be entranced by the hope of ever higher growth, ever lower interest rates, and no economic problems on the horizon.

What is graphically illustrated here is the need for a change in fiscal policy. It is my hope that the presentation here today will encourage President-elect Bush to come to the Congress with a real budget based on the best and most honest estimates of the real problems.

The new administration must join the Congress in confronting the stark reality of the deficit if we are going to get beyond playing the numbers game and give the American people a fiscal policy that will ensure the country's well-being in the decade of the 1990s and beyond.

I will turn now to our distinguished ranking member, Senator Domenici, for any comments he may wish to make.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. First, let me say how pleased I am to be here today, and clearly, I would have preferred to have been here yesterday, Mr. Chairman, rather than at the dentist, nursing my teeth.

But I want to begin, nonetheless, by repeating the words that were given in my behalf yesterday, wishing to you as chairman the very best of chairmanship. I understand that you received such wishes from Senator Gramm on my behalf yesterday, but I just want to say that we stand ready to work with you. This is a tough job and a rather thankless one.

And while I am busy thanking people, I want to thank you, Mr. Blum, for your work at CBO. You have been in a very tough position, almost an untenable one, for a long time. Through neglect on our part, collectively, we have failed to fill in a permanent manner the directorship, and you have acted in a rather extraordinary manner in the years that you have been there, and I think I speak for all members, so we thank you for that.

Mr. Chairman, I will not read my statement; instead I will respond to a few things you had to say. So, might I put my statement in the record?

Chairman SASSER. Yes. It will be included in the record.[1]

Senator DOMENICI. Mr. Chairman, can we see that graph again that you put up there with the OMB's trend line down this way and CBO's coming down not quite as fast?

Chairman SASSER. Yes. Put that chart back up, please.

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[1] See p. 10.

Senator **Domenici**. I just want to put the job ahead of us in perspective. When I was sitting in the Chairman's chair 5 years ago, that CBO line, instead of coming down at all, went up in the year 1990 to a $296 billion deficit. That was the trend line that Mr. Blum's predecessor gave us.

Some people wonder why this Senator, when I was chairman, said "Enough is enough" in some of the areas. Defense was growing at 9 percent real growth, and I said, "Why don't you take 4 percent?" and we argued around for a long time, and ended up with zero real growth. [Laughter.]

But in any event, that was some of the background that caused me to say we are doing relatively well as a nation, but we just cannot continue.

I am very pleased that the two agencies that are in charge of the economic assumptions and assessing our programmatic expenditures are that close in their deficit estimates—$14, and $12 billion—in the year that we have to produce a budget.

Now, when we leave that and look ahead 5 years, clearly, we begin the very, very complicated game of economic projections and of trying to figure out what programs would really cost.

Mr. Chairman, let me suggest to you that we are very fortunate for the year 1990, the budget that we have to produce. If you look at the differences between CBO's estimating and OMB's, they are very interesting. CBO may be right on interest costs—and the Chairman has made a point that empirical evidence right now would indicate OMB is probably wrong in the first year on interest costs. But interestingly enough, CBO estimates higher tax receipts by a coincidence——

Chairman **Sasser**. CBO is.

Senator **Domenici**. CBO's estimate is that revenues will be almost $11 billion higher, and the interest costs $11 billion higher. They kind of cancel each other out. And that leaves us, as I see it, with a fight this year not on economic assumptions but on expenditure evaluation for programs like FSLIC and defense. There are three or four areas where your different assessments of technical adjustments and costs equal the entire disparity between the two budgets for the year.

So I do not assume that President Ronald Reagan's budget on economics is so far afield that we have to start with a new economic policy or new economic indicators. I believe we have to decide whether we want to restrain expenditures to a rather significant degree or whether we want to raise taxes. And frankly, I think it is not an issue of bad policy; it is an issue of whether there is the political will—and I say that not in a pejorative sense—to restrain growth in Government or not. And if there is not, then we will not be able to get where we have to be without new taxes. If there is, I think you can get there without taxes. The question is how far can you go without them.

I believe the President's budget in that regard is a pretty good starting point.

So I thank you very much, Mr. Chairman. I was going to make the case that the American people are taxed mightily already, but I think we will get to that in due course. It is my conclusion that they are; that taxes are not too low. When you add everything up, taxes are no lower than they have been historically. What is different is expenditures are significantly higher than they have been historically. And that is a decision to be made—do you want to raise the tax end, or do you want to lower the historically high expenditure level of Government. And I do acknowledge that part of that expenditure portion is interest payments.

In conclusion, I note that you say there is a need for a change in fiscal policy, Mr. Chairman. Frankly, I do not know what you mean. I hope as we move through the process that I can get some understanding of what you mean by a new fiscal policy.

Thank you very much.

Chairman SASSER. Thank you, Senator Domenici.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT
HEARING ON CONGRESSIONAL BUDGET OFFICE ESTIMATES
SENATOR PETE V. DOMENICI
JANUARY 18, 1989

MR. CHAIRMAN, I WANT TO APOLOGIZE FOR NOT ATTENDING YESTERDAY'S, HEARING. AND YOU KNOW THAT I WOULD HAVE PREFERRED BEING HERE, RATHER THAN NURSING MY TEETH.

SO I WANT TO BEGIN BY REPEATING MY WORDS OF PRAISE AND GOOD WISHES THAT I COULD NOT DELIVER PERSONALLY YESTERDAY. I AM DELIGHTED THAT YOU ARE OUR NEW CHAIRMAN.

BUT, FRANKLY, YOU ARE LIKELY TO FIND YOUR JOB A THANKLESS ONE, YET, IF WE SUCCEED IN BRINGING THE DEFICIT DOWN --- AND I KNOW WE WILL --- I THINK YOU WILL GAIN ENORMOUS SATISFACTION FROM YOUR CONTRIBUTION. I AM SURE I SPEAK FOR ALL OF THE MEMBERS ON THIS SIDE WHEN I SAY THAT WE LOOK FORWARD TO WORKING WITH YOU.

NOW, LET ME JOIN YOUR REMARKS IN WELCOMING MR. BLUM BEFORE THE COMMITTEE. MR BLUM YOU HAVE DONE AN EXTRAORDINARY JOB AS ACTING DIRECTOR FOR THE CBO. I KNOW THAT I SPEAK FOR ALL THE MEMBERS ON THIS SIDE WHEN I SAY THANK YOU.

EVEN THOUGH SOME OF US MAY HAVE OUR DIFFERENCES WITH CBO'S FORECASTS AT VARIOUS TIMES, THESE DIFFERENCES ARE BASED ON GREAT

RESPECT FOR THE HIGH QUALITY OF CBO'S WORK. YOU, MORE THAN ANYONE ELSE, HAVE HELPED TO SUSTAIN THOSE HIGH STANDARDS. WE ARE MOST GRATEFUL.

YOUR TASK TODAY AS I UNDERSTAND IT IS TO PRESENT THE NEW CBO BASELINE ESTIMATES FOR THE BUDGET. WHILE MUCH IS MADE OF THE DIFFERENCES BETWEEN CBO AND THE ADMINISTRATION, THE FIRST POINT THAT OCCURS TO ME IS JUST HOW MUCH UNCERTAINTY IS INVOLVED IN THESE ESTIMATES.

LAST YEAR AT THIS TIME, THE ECONOMY WAS RECOVERING FROM THE AFTERMATH OF THE STOCK MARKET CRASH. ECONOMISTS GENERALLY WERE PESSIMISTIC ABOUT 1988. AS I REMEMBER, THE CONSENSUS A YEAR AGO WAS THAT THE ECONOMY WOULD GROW ONLY 2.2 PERCENT.

THE ADMINISTRATION WAS CONSIDERED WILDLY OPTIMISTIC BY PROJECTING A 2.9 PERCENT GROWTH RATE. AND YET, I GATHER THAT, MOST ECONOMISTS TODAY THINK THE ECONOMY GREW ALMOST 4 PERCENT IN 1988.

INDEED, THE MOST RECENT BLUE CHIP CONSENSUS FOR 1989 CALLS FOR 2.7 PERCENT GROWTH , A FULL HALF POINT HIGHER THAN A YEAR AGO.

MY OWN INCLINATION IS THAT THE ECONOMY IS GOING TO DO BETTER THAN MOST ECONOMISTS THINK. IT SEEMS TO ME THAT INFLATION

IS PEAKING --- NOT ACCELERATING --- AND THAT THE ECONOMY IS SETTLING NICELY INTO A SLOWER, MORE SUSTAINABLE GROWTH RATE, COMPARED TO LAST YEAR.

IT MAY BE THAT THE ADMINISTRATION IS TOO OPTIMISTIC ON INTEREST RATES FOR THE PRESENT. STILL, I THINK WE WILL FIND THAT RATES WILL DECLINE FASTER THAN EXPECTED ONCE THE MARKETS REALIZE THAT THE ECONOMY ITSELF IS IN STABILIZED GROWTH.

LET ME CONCLUDE WITH THIS OBSERVATION. ECONOMIC AND TECHNICAL DIFFERENCES ASIDE, WE HAVE COME A LONG WAY IN A FEW YEARS ON THE BUDGET DEFICIT. FOUR YEARS AGO, IN 1985, THE CBO ANNUAL REPORT PROJECTED A DEFICIT FOR FISCAL 1990 OF $296 BILLION.

EVEN THOUGH THE DIFFERENCES BETWEEN CBO AND THE ADMINISTRATION ARE NOT INSIGNIFICANT, BOTH AGENCIES PROJECT THE FISCAL 1990 DEFICIT TO BE IN THE RANGE OF $130 TO $140 BILLION -- UNDER CURRENT SERVICES. IF THIS CONGRESS, WORKING TOGETHER WITH THE ADMINISTRATION, CAN PUT TOGETHER A BUDGET CUTTING PACKAGE OF A SIZE SIMILAR TO THE 1987 BUDGET SUMMIT, WE COULD LOOK FORWARD TO ACHIEVING THE GRAMM-RUDMAN-HOLLINGS TARGETS FOR BOTH FISCAL 1990 AND 1991, NO MATTER WHOSE NUMBERS WE USE.

I THINK THAT IS AN EXCITING PROSPECT.

AND, WITH A LITTLE WILL, WE CAN DO IT.

BUT LET ME MAKE ONE FINAL OBSERVATION.

THIS COMMITTEE HEARD TESTIMONY YESTERDAY HEARD TESTIMONY FROM THE COUNCIL ON COMPETITIVENESS. I UNDERSTAND IT WAS HELPFUL AND WELL THOUGHT OUT TESTIMONY. BUT I ALSO UNDERSTAND THAT THE COUNCIL RECOMMENDED ONLY $48 BILLION IN SPENDING CUTS BY FISCAL 1993. THIS WOULD COVER ONLY JUST OVER ONE-THIRD OF THE DEFICIT REDUCTION, AS DEFINED IN THE CBO TESTIMONY.

IF THIS IS ALL THAT WE CAN CUT FROM FEDERAL SPENDING --- THEN WE WILL HAVE A REAL PROBLEM. A DISCRETIONARY FREEZE OVER THE SAME PERIOD WOULD SAVE $73 BILLION, AND THAT IS WITHOUT ANY CHANGES IN ENTITLEMENT PROGRAMS.

MR. CHAIRMAN, LET ME GIVE YOU A FEW NUMBERS. I CALCULATED THAT ALL GOVERNMENT SPENDING IN THIS NATION --- FEDERAL, STATE AND LOCAL --- TOTALS $16,722 PER-HOUSEHOLD IN AMERICA, WHILE MEDIAN HOUSEHOLD INCOME IS $25,000. TAKE AWAY DEFENSE SPENDING, AND THE PER-HOUSEHOLD SPENDING BY GOVERNMENT STILL TOTALS $13,589.

WE HAVE AN OBLIGATION TO THE AMERICAN PEOPLE TO BRING THIS NUMBER DOWN AS MUCH AS POSSIBLE BEFORE WE RAISE TAXES TO PAY FOR MORE SPENDING. THIS IS MY STRONG VIEW, MR. CHAIRMAN, AND IT IS ONE I EXPECT THE PRESIDENT-ELECT SHARES.

IN CONTRAST TO THE PESSIMISTS, I AM CONVINCED WE CAN CUT MORE FROM SPENDING THAN MANY NOW BELIEVE. JUST REMEMBER THAT NUMBER FOR CURRENT NON-DEFENSE SPENDING --- $13, 589.

SO, AT THIS EARLY STAGE, MR. CHAIRMAN, LET ME VOICE SOME OPTIMISM. I KNOW WE CAN DO IT WITHOUT MORE TAXES.

AND I LOOK FORWARD TO OUR WORKING TOGETHER TO ACHIEVE THAT GOAL.

Chairman SASSER. I might say as an aside that these figures and these projections of the deficit are not as grim as they were in 1984 and 1985. Many of us remember at that time your Herculean efforts to try to control the growth of the deficit, and you were successful. Many of us were pleased to work with you in that effort. I think it is partly as a result of your efforts and the bipartisan cooperation on the Senate Budget Committee that we were able to dampen some of the deficits in the outyears.

So I would agree, our task is not as formidable as it was 2 or 3 or 4 years ago, but still we have got a long way to go.

Senator Conrad.

OPENING STATEMENT OF SENATOR CONRAD

Senator CONRAD. Thank you, Mr. Chairman.

I had different remarks than I thought I would give at this point, but I must say sometimes I think we lose the forest for the trees. While we are better off than those very serious projections indicated a number of years ago, new is certainly not good.

And the fact is we have tripled the national debt in 8 years in this country—tripled the national debt.

The trade deficit has multiplied sixfold. We have gone from being the biggest creditor nation to the biggest debtor nation. I keep repeating myself on this issue because for some reason, it seems to me we lose sight of where we are.

I believe we are posed with the most significant threat to the economic security of this country that we have faced in a very long time, and it is because of a fiscal policy that does not add up. It does not add up now, has not added up and will not add up unless we make some changes in direction.

And I would share the feelings of the Senator from New Mexico that that means some very tough spending restraint. That is the first order of the day. And then we will have to see from there what is necessary to bring this serious situation into balance. Otherwise, we are going to wake up in a few years and find that we have quadrupled the national debt, with all kinds of implications.

The Senator from New Mexico points out, as we have heard many times, that it is all on the spending side of the equation, that historically as a percentage of GNP, revenues are about the same as they have been; it is spending as a percentage of GNP that has gone up. And I think it is important just to put that in context. It is only in two areas that we are off the historical trend line. That is on interest on the debt, up from a historical average, as I recall, of about 1.3 percent of GNP to 3.2 percent of GNP; and the second area is social security. As I recall, we have gone from 2.7 percent of GNP in the 60's to 4.6 percent of GNP.

So the greatest in spending on a historical basis is in just two areas. And the biggest one of those is interest on the debt.

So spending in all the other areas combined as a percentage of GNP has declined by historical standards. Now it is time to face up to reality. Mr. Blum, I think you have done an excellent job of coming before us and pointing out the challenge that we face. I just hope that all of us are able to summon the political will that the

Senator from New Mexico has alluded to; summon the political will to do what must be done.

I just returned from Asia, and all over the Far East, people are watching America and wondering if we are going to have the discipline to master our destiny.

Mr. Chairman, I want to again commend you publicly for putting together these hearings early on so that we start this budget cycle with an early assessment of where we are and where we need to be.

Chairman SASSER. Thank you, Senator Conrad.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Thank you, Mr. Chairman.

Mr. Chairman, I appreciate having an opportunity to be here. I would like to join my voice with yours in saying that historically, the Congressional Budget Office has been a bipartisan institution that has served well the public interest. I hope that will always be the case.

Mr. Chairman, I think it is important to note as we enter the budget debate that Ronald Reagan is the first President in 36 years to leave office under conditions where both inflation and unemployment are lower the day he leaves office than they were the day he entered office.

That is important to the budget—and relevant to our present debate. Obviously, we had a political campaign, we elected a President, we had two views presented at that time—one was that America was going to hell in a hand-basket, and the other was that we had made great progress. The American people listened attentively and decided which view reflected reality. So I do not think we are going to do any good by redebating that here today in our deliberations.

But what is relevant about the economic progress that we have sustained since 1982, and we are sustaining today, is that despite the conservative estimates concerning economic growth and concerning higher interest rates, the Congressional Budget Office and the numbers being presented to us today tell us that revenues are likely to be $86 billion larger in fiscal year 1990 than they were in fiscal year 1989 without any increase in taxes or without the imposition of new taxes other than what is currently the law of the land.

Due to economic growth, due to national prosperity, the private sector is contributing $86 billion more to deficit reduction this year than it did last year.

I think as we enter the budget debate, it is important that we remember that the fundamental fact of this debate is that $86 billion is coming in through the front door without an increase in taxes.

To meet the targets of the Gramm-Rudman-Hollings balanced budget law, somewhere around $50 to $55 billion has to be applied to reduce the deficit. That means that if you define spending cuts and spending growth the way the guy in the street does, where cutting spending is spending less than you used to spend, not less than you would have spent, the bottom line constraint we face is that we can meet the deficit reduction targets by limiting the growth of Federal spending to about 3 percent above the level we spent at last year.

Now, we all know, Mr. Chairman, that that is a tough task. But on the other hand, I ask anybody to submit to the American people the simple question: Are you willing to raise taxes so that Government spending can grow by more than 3 percent above the level that Government expended last year? I submit that not 1 out of 10 Americans would answer that question "Yes".

I submit that as a result of that, we are going to see throughout this debate a continued attempt to change the meaning of words. Many will call a limit in the growth of Federal spending to 3 percent a cut in spending, because in fact there are many who would like to see Federal spending grow by 6 percent or 7 percent, and therefore the question will invariably be changed—not are you willing to raise taxes so that Government will not have to constrain spending growth to 3 percent, but are you willing to raise taxes so we will not have to cut spending.

I submit, Mr. Chairman, that that is a misuse of the English language. I for one think the answer to the question about should we raise taxes so that Federal spending can grow faster than 3 percent is clearly "No", and I think the burden of proof is going to be on those who say "Yes".

So I look forward to this debate. I congratulate you for moving out quickly even in this inaugural week. I think ultimately, we need to adopt a budget, we need to move ahead. I think the greatest tragedy that could befall the country would be for us to simply do nothing, and that clearly is not the chairman's intention, and I congratulate him on that.

Chairman SASSER. Thank you, Senator Gramm.

Senator Sanford.

OPENING STATEMENT OF SENATOR SANFORD

Senator SANFORD. Thank you very much, Mr. Chairman.

Mr. Blum, I want to thank you for being here and thank you for the information that you have been kind enough to furnish me on various requests. I certainly appreciate the good work that you and your staff at the Congressional Budget Office do, and I am looking forward to reading very carefully the entire outlook report.

I agree with my distinguished colleague from Texas that we have got to not change the use of the English language. I do not know of anybody, really, who is asking for increases in taxes to spend for growth. I think what we must do, though, is define exactly where we are and what the debate is about. I do not think the debate is about spending. The debate is about the Federal debt that nobody ever pays any attention to, and somehow gets concealed with the Gramm-Rudman-Hollings procedures.

So we have this debt growing at a quarter of a trillion dollars a year, but we announce that the deficit, it is getting lower and lower, when it is increasing. A few years ago, there were little buttons that said "108 in '88"—about the silliest thing I have ever seen around here. "108 in '88" did not mean a thing. We had a $225 or $230 billion deficit that year.

Now, most of us in this room agree that the Federal deficit and increasing Federal debt is what poses the serious threat to the future of this country. It is not the spending, because that cannot get out-of-hand under our present rules. It is not really the deficit. It is the accumulation of deficit—the debt—that we somehow manage to conceal.

So eliminating the true deficit and reducing the debt to a far more reasonable level, it seems to me, is the first order of business of the 101st Congress.

I believe that before we can begin to effectively tackle our fiscal problems, we must first fully understand the true size of this problem. We are dabbing at a nosebleed and not paying a bit of attention to the fact that blood is gushing from the jugular.

We must first lay out the Federal budget, total income and outgo, in an honest and straightforward way, and we do not now do that.

We cannot continue making the true size of the Federal deficit seem to be smaller by using trust fund surpluses. When we quit using them after we eliminate the Gramm-Rudman defict in 1993, we are going to find that we still have a large deficit.

We cannot continue to fool the American public, and I say cannot continue to fool ourselves by suggesting that under Gramm-Rudman-Hollings, we are reducing the deficit, when in reality, every year, our true deficit and the increase in the national debt continues to rise.

So I think we have got to deal with this in a forthright way. We know that there is a great difference between the deficit shown in the budget and the deficit shown as the accumulation of the national debt. The debt is our problem.

I think we must simply lay out the deficit in the budget for what it is. And I think we have got to quit covering it up with the social security and other trust funds. And I think we have got to even stop covering it up as we do by taking credit for interest that is paid to the trust funds. The figure of net interest is not all the interest that is paid by the Government in the form of additional borrowing, either converting cash to pay for the public interest, or to have securities that obligate the Government to pay the various social security and other governmental agencies.

We have been treating that as income, when it is not income, because the Government cannot use it to pay off the debt. It is paid to a Government agency —to an agency as trustee, maybe for pensioners, maybe for highway users, maybe for the Annapolis Club Fund or some such thing, as one of the many accounts—but we do not have the use of that money.

What I am saying is that I hope as we proceed with these hearings that we find a way to let the Congress and the public know that we are running up about a quarter of a trillion dollars a year. In 4 more years the debt will reach $4 trillion if we do not do something about it. I think that is so important. We have just got to get the full facts out.

Thank you.

Chairman SASSER. Thank you, Senator Sanford.

Senator Grassley.

OPENING STATEMENT OF SENATOR GRASSLEY

Senator GRASSLEY. Mr. Chairman, I thank you very much for the opportunity early on in this Congress to face these very difficult issues that come before us, thank you for calling the early meetings you have. I hope that that is an indication not only substantively of your willingness to really grab the bull by the horns, but also procedurally, starting as early as you are to keep our nose to the grindstone and get things done timely. Not only has substance been difficult for this committee to accomplish in the past, but it has also been difficult for us to do it in a timely fashion. And I think maybe your holding these early hearings is an indication of your desire to do that.

Mr. Blum, I do not know whether I will be able to be here when you finish your presentation and my turn for questions comes, but I am going to be asking things along the line of what a freeze will do. I was an early advocate for across-the-board freezes, and in years when a freeze would have accomplished meaningful deficit reduction. I fear that we all know that across-the-board cuts do not do a whole lot today, but I think we need your expertise on that.

I would like to know if we would be able to meet the Gramm-Rudman targets if we froze all discretionary spending. Let us suppose we froze all COLAs except social security, plus adopted the President's medicare savings. My question to you would be, at my time for questioning—and if I am not here, please answer it in writing—how close would we come, then, to the $100 billion Gramm-Rudman target?

[The following material was subsequently supplied for the record by CBO:]

Illustrative Budget Plan, Fiscal Year 1990

[In billions of dollars]

CBO baseline deficit	146.3
Policy changes:	
Freeze defense budget authority	−5.7
Freeze nondefense discretionary budget authority	−5.8
Freeze COLAs, excluding Social Security	−4.0
Adopt Reagan administration Medicare proposals	−5.0
Debt service savings	−0.9
Total policy changes	−21.3
Resulting deficit	−124.9

I think that what we really need to know is how much action is necessary beyond doing these minimal things. I think that is very easily quantifiable.

It seems to me, Mr. Chairman, that although chairmen of this committee come and go, we still face the same choices each year. Either we can do disciplined cuts, or we can do smoke-and-mirrors and minimal cuts. And it seems that we have always opted for the minimal cuts, which is why we have made minimal progress on the deficit. I hope that somehow we can find the political will to break from that tradition under your leadership, Mr. Chairman, and find a way to play catch-up to the recent years of doing the bare minimum in cutting spending.

If we can assume taxes will not be raised this year, let us do the maximum for a change on the spending side. And I trust that you would have a good degree of support from this committee. I also think you have got a mandate from the people of this country, judging from the 40-State margin of victory for Bush in the election.

Now, the point is do you have a majority of this committee on your side, and only time will tell.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you very much, Senator Grassley.

I want to welcome this morning Senator Robb, another new member of our committee. Senator Robb, we are delighted to have you on this committee, and we are pleased to have you here this morning. I am confident that you are going to make some significant and constructive contributions to this whole dialogue on the question of budget, what is to be done about the deficit, et cetera, in the coming weeks and months.

So welcome to the committee, and feel free to offer any observation that you might have this morning. Otherwise, I want to also advise you, you have the right to remain silent if you wish to do so. [Laughter.]

OPENING STATEMENT OF SENATOR ROBB

Senator ROBB. Mr. Chairman, thank you.

I am delighted to be one of your new members. I look forward to service on this committee. I would probably be well-advised to take your advice to remain silent at this point, but I have had more than a little to say about the budget for a number of years, the Federal budget, and no authority to do anything. One of the reasons I sought membership on this committee was to work with you and the members to see if we cannot pursue some of the goals that you have outlined, and I regret that I am already coming into conflict with the overlap of committee assignments. With the confirmation process for Secretary Baker over in Foreign Relations, I have had to be back and forth, and I am going to have to slip back again, as Senator Sanford and others here have done.

But I happened to be here in time to hear Senator Sanford's remarks, and I do not know anything that I could find to quarrel with. If he represents what I hope would be ultimately the feeling of the committee as to the kinds of goals we ought to approach and what we ought to do, then I would join happily in the remarks that I heard from the distinguished Senator from North Carolina.

I come with a great deal of passion but no Federal budget experience. I do have a fair amount of budget experience at the State level, and I think I have some understanding, at least on a micro level, of the kinds of decisions and trade-offs and public pressures that are going to be brought to bear on this committee. I would have to tell you that virtually all of my principal friends and advisors said if you want to serve more than one term in the Senate, do not get on the Budget Committee, because you are going to have to make everybody mad. And I said that is the reason I want to get on the committee.

So I join you with a spirit of willingness to try to make some of the tough decisions that I hope that we can encourage the executive branch to join in and to achieve some of the goals I think all of us recognize.

But again, if I were to cite a specific reference, Senator Sanford's remarks as to what we might do, I would be pleased to join those remarks.

I thank you and look forward to working with you.

Chairman SASSER. Thank you very much, Senator Robb.

I might observe that you may very well find that no Federal budget experience will be an asset to you on this committee.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman.

I was fortunate to hear the comments of my good friend from Texas as I came in. I think there is much that we can take to heart from those comments.

When we take a look at the CBO and OMB baselines, along with other projections which show consistently increasing Federal expenditures, it is well to realize that if we put limits on those increases, we are not actually cutting a program—instead we are slowing their growth.

I note with a great deal of enthusiasm that I am joining at least two of my former colleagues as Governors on this committee. When we were in the Governor's chair, at least in my State, we did not have the opportunity to print money to balance the budget or borrow funds; we had to make the expenditures fit the available revenues. And I do not know whether they had the same experience I had of being hanged in effigy for making those cuts, but perhaps we do have a need, as Senator Robb said, for some courage in imposing fiscal discipline. I can assure you it is not popular, but it is necessary if we are to assure that the growth in our economy continues and that we do not put increasing burdens of inflation on the backs of those who are unable to sustain it.

I was interested to read in today's *Washington Post* that an astute economist, Mr. Samuelson, observed that the many issues facing us when taken together, intensify pressure to raise already high taxes. Unfortunately, Mr. Samuelson then folds to that pressure and recommends increasing cigarette, alcohol, and gasoline taxes, which would impact most heavily on those least able to pay the bills. And then he goes on to note that the tax burden in 1987 hit a postwar high of 30.2 percent of our gross national product when you take into account Federal, State, and local taxes. I think that is a significant figure, and I would hope that in this committee and with our colleagues in the Congress, we could make a dedicated and effective effort to keep our spending within the Gramm-Rudman-Hollings guidelines without yielding to the temptation to cave to the pressure to raise those already high taxes.

Mr. Chairman, I appreciate the opportunity to be here.

Chairman SASSER. Thank you very much, Senator Bond.

We will turn now to Mr. Blum, the Acting Director of the Congressional Budget Office. Welcome, Mr. Blum. We are delighted to have you here, and we look forward to your testimony.

For the purpose of the record, Mr. Blum, if you would be kind enough to identify your colleagues there from CBO who are sitting at the table with you, and then proceed.

STATEMENT OF JAMES L. BLUM, ACTING DIRECTOR AND ASSISTANT DIRECTOR FOR BUDGET ANALYSIS, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY ROSEMARY MARCUSS, ASSISTANT DIRECTOR FOR TAX ANALYSIS, CBO, AND FRED RIBE, ASSISTANT DIRECTOR FOR FISCAL ANALYSIS, CBO

Mr. Blum. Thank you, Mr. Chairman.

It is indeed a pleasure for us to be here this morning and to discuss with the committee our latest economic and budget baseline projections.

I am accompanied this morning by Rosemary Marcuss, on my right, who is the Assistant Director for Tax Analysis—that is the group that is responsible for producing the revenue estimates at the Congressional Budget Office. On my left is Fred Ribe, who is the Assistant Director for Fiscal Analysis at CBO and is responsible for producing the economic forecast and the longer-run economic assumptions that we use for making budget projections.

I would like to thank Senator Domenici in particular and Senators Sanford, Conrad and others, who had very nice words to say about us at CBO, and we certainly take those to heart and appreciate them greatly.

Now, the CBO economic and budget projections are well known. As a matter of fact, Mr. Chairman, you described them very well in your opening remarks. We did distribute these, in advance copies, to all the members of the committee earlier this month. Our full report, which will discuss these projections in great detail, will be released next week; it will be back from the printer's, we hope, on Tuesday. These numbers, the budget numbers, are subject to slight changes as we bore through the President's budget, and to the extent we glean any information there that we think should be taken into account for purposes of baseline projections.

I think in the interest of time, Mr. Chairman, I would ask that my statement be included in the record, and let me just quickly summarize some of the highlights and call your attention to some of the key points.

The baseline budget projections are summarized in table 1 on page 3,[1] and I think I would like to call the committee's attention to essentially two points. First of all, these baseline projections generally follow the specifications set forth in the Balanced Budget Reaffirmation Act, popularly known as the Gramm-Rudman-Hollings Act, for making these projections. In other words, the revenues and the entitlements are based on current law; the discretionary spending, both defense and nondefense, is adjusted only for inflation, taking the latest appropriation action.

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[1] See p. 28.

It is this last assumption that is responsible for outlays and deficits falling as a percentage of GNP over the projection period. As you see from this table, the deficit as a percentage of GNP, under our assumptions, falls from 3 percent in 1989 to 1.7 percent in 1994.

Most of that, almost all of that, is attributable to this assumption of zero real growth for discretionary spending.

Table 2, on page 5,[2] shows how these baseline projections have changed since last August when we presented our August update report. The bottom line is that they have not changed much at all; the essentially programmatic assumptions, or technical reestimates, account for most of the change, and when we look closely it is the cost of deposit insurance that explains the bulk of that.

If we were to go back to the projections of February or March a year ago, we would see a somewhat different picture—the deficits we are projecting now are much lower than we were projecting a year ago, and that is because of the very strong economic growth we had during 1988.

With respect to the social security surpluses, these are laid out in table 3 on page 8,[3] and they were depicted graphically by you, Mr. Chairman, during your opening remarks.

I think the key area to focus on is our economic assumptions. You are correct, Mr. Chairman, in pointing out that the differences between the CBO baseline estimates on the one hand and the OMB current services projections on the other are largely attributable to differences in the economic assumptions that underlie these budget estimates. And I think it would be useful to highlight what lies behind the economic forecast of CBO.

Our forecast assumes, critically, that the Federal Reserve will be successful in holding the economy to a growth rate that will avoid a sharp increase in inflation, and furthermore that the 1990 budget deficit will be reduced to satisfy the Gramm-Rudman-Hollings deficit target.

The rate of growth in real GNP, if we look on table 4 on page 10,[2] on a fourth-quarter-over-fourth-quarter basis, is projected to grow at 2.9 percent in 1989—a slight increase over what occurred in 1988—but then to fall off to 2.2 percent in 1990.

Now, if we exclude the farm sector, which was particularly hard-hit by the drought last summer, the growth rate declines more smoothly—from 3.5 percent in 1988 to 2.1 percent in 1989 and 2.2 percent in 1990, essentially a flat rate of growth in the next 2 years.

Unemployment therefore is estimated to stay roughly constant at around 5.5 percent. Net exports and business fixed investments are expected to be the main sources of economic growth during the next 2 years. We do not expect that those will contribute as much, though, during the next 2 years, as in fact they have contributed in 1988.

I might point out, with respect to the uncertainty of our forecast, that we think it represents only one of many paths that the economy can take over the next 2 years. Table 4 compares our forecast not only with that of the administration, but also with the consensus of private forecasters who are polled monthly by the *Blue Chip* survey. Our forecast turns out to be much closer to the *Blue Chip* consensus than to the administration's, but I would point out that many forecasters in the *Blue Chip* survey expect to see a recession either in the beginning of 1989 or in 1990. That is not foreseen in our forecast. But there is fear among economists that monetary tightening by the Federal Reserve Board could result in a "hard landing," and I think there are many forecasters who anticipate such a result.

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[2] See p. 30.

[3] See p. 33.

Other forecasts, notably that of the Reagan administration in its latest budget, are more optimistic than CBO regarding both inflation and economic growth, and we can talk about that later in the hearing.

I would just point out that our assumptions for 1991 through 1994, which are displayed in table 5 on page 14,[4] are not a forecast of future economic conditions. Rather, these are projections based on past trends. No one really has a crystal ball that will foresee exactly how the economy will perform over the longer run, and we think the prudent course to take is to use historical trends as a benchmark. Because the economy essentially is operating at close to capacity, we expect that the trend rate of growth will prevail over this period of time, with real growth in the 2 to 2.5 percent range; that inflation after running up a little bit in 1989 and 1990, will settle down to essentially its historical rate, around 4 percent; and that interest rates will decline marginally over this period.

I think, Mr. Chairman, these statements cover the highlights of the forecast, and we would be delighted to answer any questions that you and other members of the committee might have.

Chairman SASSER. Well, thank you very much, Mr. Blum.

[The prepared statement of Mr. Blum follows:]

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[4] See p. 39.

Statement of
James L. Blum
Acting Director and
Assistant Director for Budget Analysis
Congressional Budget Office

before the
Committee on the Budget
United States Senate

January 18, 1989

Mr. Chairman, I am pleased to appear before the committee this morning to discuss the latest economic and budget projections of the Congressional Budget Office (CBO). These projections will be described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1990-1994*, which will be formally released on Tuesday, January 24. Earlier, each of you received an advance summary of the report.

The American economy is making almost full use of both its labor force and its capital stock. The latest unemployment rate is 5.3 percent, the lowest level in 14 years, and factories are operating at high levels of capacity. Because these high operating rates threaten to increase inflation, monetary restraint is likely to slow the economy's growth from recent high rates to a more sustainable trend. As a result, further reductions in the federal budget deficit will probably be modest if spending reductions or tax increases do not take place.

CBO now estimates the budget deficit for 1989 to be $155 billion, about what it was in 1988. Under current budgetary policies, the deficit is projected to decline slowly thereafter--to $141 billion in 1990, $140 billion in 1991, and $122 billion in 1994. These figures exceed by increasing amounts the deficit targets specified in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Public Law 100-119).

THE BUDGET OUTLOOK

CBO's baseline budget projections portray what would happen if current budgetary policies were continued without change. They are not a forecast of future budget outcomes, since the future will include many policy changes. The methodology for the baseline projections follows closely the specifications contained in the Reaffirmation Act. For revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense and nondefense discretionary spending, the projections for 1990 through 1994 are based on the 1989 appropriations, increased only to keep pace with inflation. As a result, the baseline makes no explicit allowance for activities not included in the 1989 appropriations, such as conducting the decennial Census of Population, building the manned space station or the superconducting super collider, fully resolving the savings and loan situation, renewing long-term subsidized housing contracts that are about to expire, buying more B-2 bombers, or modernizing nuclear weapons plants.

Baseline Budget Projections

CBO's baseline budget projections are presented in Table 1. The assumption of no real growth in discretionary spending causes both total outlays and the deficit to decline in relation to the growing economy. Outlays fall from an estimated 22.2 percent of gross national product (GNP) in 1989 and 1990, to 22.0 percent in 1991, and 21.1 percent in 1994. Revenues, on the other hand, are projected to increase from 19.2 percent of GNP in 1989 to 19.6 percent in 1990 and 1991, then taper off to 19.4 percent by 1994. The 1990 increase results primarily from the income tax surcharge on Medicare beneficiaries for catastrophic health insurance, a scheduled increase in Social Security

TABLE 1. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1988	1989	1990	1991	1992	1993	1994
			In Billions of Dollars				
Revenues	909	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,064	1,138	1,209	1,280	1,344	1,410	1,480
Deficit	155	155	141	140	135	129	122
Deficit Targets[a]	144	136	100	64	28	0	--
			As Percentages of GNP				
Revenues	19.0	19.2	19.6	19.6	19.5	19.5	19.4
Outlays	22.3	22.2	22.2	22.0	21.7	21.4	21.1
Deficit	3.2	3.0	2.6	2.4	2.2	2.0	1.7

SOURCE: Congressional Budget Office.

NOTE: The baseline estimates include Social Security, which is off-budget.

[a] The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 established targets for 1988 through 1993.

payroll taxes, and the phasing in of certain provisions of the Tax Reform Act of 1986. The deficit falls from 3.0 percent of GNP in 1989 to 2.6 percent in 1990 and 1.7 percent in 1994. This improvement, however, falls short of that required by the Balanced Budget Act, which mandates a balanced budget by 1993.

For 1990, the deficit target is $100 billion, and the deficit must be held below $110 billion to avoid automatic spending reductions, or sequestration. CBO's deficit estimate of $141 billion exceeds the target by $41 billion. The Reaffirmation Act, however, gives CBO only an advisory role in the sequestration process. Under the terms of the act, the Director of the Office of Management and Budget (OMB) alone determines whether or not automatic spending cuts are necessary and how large the cuts must be. In President Reagan's fiscal year 1990 budget, OMB estimated that the 1990 base deficit for purposes of the Balanced Budget Act is $126 billion, ignoring statutory limitations on spendout rates. If OMB comes up with a similar estimate this summer, only $16 billion in deficit reduction will be required to avoid sequestration.

Changes Since August

CBO's new baseline budget projections reflect all legislation enacted during the second session of the 100th Congress and are based on up-to-date economic and technical estimating assumptions. The new projections are only modestly higher than those published in CBO's August 1988 report, as shown in Table 2. The largest revisions stem from changes in technical estimating assumptions, which add between $6 billion and $11 billion annually to the baseline deficits.

TABLE 2. CHANGES IN CBO DEFICIT PROJECTIONS SINCE AUGUST (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
August 1988 Projections[a]	148	136	131	126	121	121
Changes for:						
Enacted legislation	1	1	1	b	-1	-5
Updated economic assumptions						
Revenues[c]	-5	-6	-8	-7	-5	-5
Net interest	5	4	4	4	3	1
Other outlays	b	b	1	2	2	2
Subtotal	b	-3	-3	-1	b	-2
Technical reestimates						
Revenues[c]	1	2	2	1	b	b
National defense	-2	-2	-2	-2	-1	-1
Deposit insurance	7	8	10	6	5	5
Other outlays	1	-1	2	5	5	2
Subtotal	7	6	11	9	9	8
Total changes	7	5	9	9	8	1
January 1989 Projections[a]	155	141	140	135	129	122

SOURCE: Congressional Budget Office.

a. The baseline projections include Social Security, which is off-budget.

b. Less than $500 million.

c. Revenue increases are shown with a negative sign because they reduce the deficit.

Most of this increase is attributable to higher expected outlays for the deposit insurance activities of the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation. Although FSLIC has virtually no cash on hand, it is piecing together resources from a variety of sources to enable it to continue closing and selling insolvent institutions. While the new baseline has added more than $30 billion to FSLIC outlays over the next six years, mostly made possible by borrowing from the Federal Home Loan Bank System, thrift institutions are likely to need even more assistance during the early 1990s. The budgetary impact of the additional assistance would depend, however, on the specifics of the financing plan.

Recently enacted legislation adds $1 billion or less per year to the deficit through 1992, but decreases it by $1 billion in 1993 and $5 billion in 1994, primarily because of the delayed effects of lower 1989 defense appropriations. Changes in the economic outlook reduce the deficit by no more than $3 billion in any year. Revenues are higher by $5 billion to $8 billion per year, but the gain in revenue is largely offset by the increased costs of debt service resulting from higher interest rates.

Social Security Surpluses

Accurately measuring the government's borrowing needs and its impact on the economy requires counting all revenues and spending. The previous tables have therefore displayed figures for total revenues, outlays, and the deficit. At the same time, the Balanced Budget Act requires that the Social Security trust funds be shown as off-budget, a treatment that highlights their contribution to the totals. With income of the trust funds exceeding benefits and other costs, the Social Security surplus grows from $56 billion in 1989 to $117 billion in 1994, as shown in Table 3. The on-budget deficit, on the other hand, rises from $211 billion in 1989 to $239 billion in 1994.

An increasing portion of the Social Security surplus results from interest income earned on the growing trust fund balances, which are invested in government securities. Social Security's interest income grows from $11 billion in 1989 to $45 billion in 1994. These interest payments are an intragovernmental transaction; since they contribute identically to the on-budget deficit and to the off-budget surplus, they do not affect the total deficit. Ignoring these intragovernmental payments, the non-Social Security deficit declines slightly, and the Social Security surplus rises less rapidly.

TABLE 3. ON- AND OFF-BUDGET TOTALS
(By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993	1994
Off-Budget (Social Security)						
Revenues	267	290	312	333	355	379
Outlays	211	222	234	243	252	261
Surplus	56	68	79	90	103	117
On-Budget (All Other Programs)						
Revenues	715	779	828	876	925	980
Outlays	926	988	1,047	1,101	1,158	1,219
Deficit	211	209	219	225	233	239
Total						
Revenues	983	1,069	1,140	1,209	1,280	1,359
Outlays	1,138	1,209	1,280	1,344	1,410	1,480
Deficit	155	141	140	135	129	122

SOURCE: Congressional Budget Office.

THE ECONOMIC OUTLOOK

The long-run rate of growth of the economy's productive capacity, CBO estimates, is about 2½ percent a year. In the aftermath of a recession, when much capacity is unused, the economy can easily grow more rapidly than this trend. But after six years of expansion, the American economy is now employing almost all its capacity. If the economy were to con-tinue growing at its recent rapid rate, inflation would probably increase. The Federal Reserve has therefore sought to slow economic growth to a pace that is sustainable over the long haul.

Forecast for 1989 and 1990

CBO's short-term economic forecast for 1989 and 1990 is shown in Table 4. The forecast assumes that the Federal Reserve will be successful in holding the economy's growth to a rate that will avoid a sharp increase in inflation, and that the 1990 deficit will be reduced to satisfy the Reaffirmation Act's requirements.

The rate of growth of real gross national product, estimated to be 2.6 percent during the four quarters of 1988, is expected to rise to 2.9 percent in 1989 and drop back to 2.2 percent in 1990. Excluding the farm sector, which was hard hit by last summer's drought, the growth rate declines more smoothly--from 3.5 percent in 1988 to 2.1 percent in 1989 and 2.2 percent in 1990. Unemployment is expected to remain near its current level of about 5½ percent. Net exports and business fixed investment are expected to be the major sources of economic expansion in the next two years. Because of the temporary strength of the dollar in mid-1988, however, the rate of improvement in real net exports is likely to be slower in 1989 and 1990 than it was in 1988.

TABLE 4. COMPARISON OF ADMINISTRATION, CBO, AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Estimated	Forecast	
	1988	1989	1990
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	2.6	3.5	3.4
CBO	2.6	2.9	2.2
Blue Chip	2.8	2.3	1.9
Nominal GNP			
Administration	6.6	7.4	7.0
CBO	6.7	6.9	6.6
Blue Chip	6.9	6.7	6.3
Consumer Price Index[a]			
Administration	4.2	3.6	3.5
CBO	4.3	5.0	4.8
Blue Chip	4.4	4.8	4.7
Calendar-Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	6.7	6.3	5.5
CBO	6.7	7.9	7.1
Blue Chip	6.7	7.8	7.3
Ten-Year Government Note Rate			
Administration	8.9	8.3	7.2
CBO	8.9	9.3	9.0
Blue Chip[b]	8.9	9.0	8.4
Civilian Unemployment Rate			
Administration[c]	5.4	5.2	5.1
CBO	5.5	5.5	5.5
Blue Chip	5.5	5.4	5.7

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1989). The CBO forecast is based on preliminary 1988 fourth-quarter data published in January 1989.

a. Consumer Price Index for urban wage earners and clerical workers.

b. *Blue Chip* does not project a ten-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate, adjusted by CBO to reflect the estimated spread between AAA bonds and ten-year government notes.

c. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

CBO projects that consumer price inflation will increase from 4.3 percent in 1988 to 5.0 percent in 1989, both from increases in food prices and from higher import prices. Because wage growth is likely to accelerate, inflation is not expected to subside much in 1990. Interest rates will remain high in the first half of 1989, as restraint continues. Rates are forecast to ease somewhat later in 1989 and in 1990, reflecting the central bank's success in holding growth to the range of 2 percent to 2½ percent.

Uncertainty in the Forecast

CBO's short-run forecast represents only one of the many paths that the economy might take over the next two years. We believe, however, that the forecast lies roughly in the middle of the possible outcomes. It is also close to the average of the 50 private-sector forecasts summarized in *Blue Chip Economic Indicators*, as shown in Table 4.

Most forecasters agree that the Federal Reserve's effort to control inflation is the key source of uncertainty in the economy today. Even under the best of circumstances, it is difficult for monetary policy to slow the economy gradually. The economy may continue to grow rapidly in spite of monetary tightening, thereby provoking higher inflation, further tightening, a rapid increase in interest rates, and possibly a recession. Today the Federal Reserve's task is also complicated by the volatility of the dollar, the shaky condition of a number of thrift institutions and banks, the debt problems of developing countries, and the higher degree of corporate financial leveraging. Although CBO forecasts a smooth slowing in growth through 1989, a number of private forecasters expect a recession to begin this year.

Other forecasts, notably that of the Reagan Administration, are considerably more optimistic than CBO on the outlook for inflation and economic growth. The Administration forecasts fourth-quarter-to-fourth-quarter real growth rates that exceed CBO's by 0.6 percentage points in 1989 and 1.2 percentage points in 1990 (see Table 4). Inflation is more than a percentage point lower, as are interest rates. This more favorable outlook assumes that the potential for noninflationary growth is greater than estimated by CBO. The Administration projects that productivity will grow about 2 percent a year, which is near the post-World War II average. In recent years, however, the growth of productivity has been substantially less, and the CBO forecast assumes that growth of productivity will continue at the slower recent rates. If the Administration's view were to prove more accurate, continued strong growth may not be quickly followed by higher inflation, and the Federal Reserve may not feel the need to tighten further.

These alternative views of developments in the next two years indicate the range of possibilities. Neither a recession nor a spurt in productivity can be completely ruled out. The CBO forecast, however, gives some weight to both views and should be a prudent guide to policy planning. In CBO's judgment, the economy's actual growth over the next two years is equally likely to be lower or higher than our forecast.

Projections for 1991 Through 1994

For 1991 through 1994, CBO's economic assumptions are not a forecast of future economic conditions but are projections based on past trends. Real GNP is projected to grow at an average annual rate of 2.2 percent, as shown in Table 5, and the unemployment rate remains close to current levels. The inflation rate as measured by the Consumer Price Index is projected to decline moderately after 1990 and stabilize around 4 percent. Interest rates are projected to decline throughout the 1991-1994 period until they reach levels consistent with the average of inflation-adjusted interest rates since 1973. In 1994, the three-month Treasury bill rate is assumed to be 5.9 percent, and the ten-year government note rate is projected to be 7.4 percent.

TABLE 5. COMPARISON OF ADMINISTRATION AND CBO ECONOMIC ASSUMPTIONS, 1989-1994 (By calendar year)

	Estimated	Forecast		Projected			
	1988	1989	1990	1991	1992	1993	1994
Nominal GNP (Billions of dollars)							
Administration	4,857	5,211	5,570	5,939	6,296	6,640	6,968
CBO	4,859	5,209	5,542	5,902	6,281	6,685	7,117
Real GNP (Percent change, year over year)							
Administration	3.8	3.2	3.2	3.3	3.2	3.2	3.2
CBO	3.8	2.9	2.1	2.2	2.2	2.3	2.3
Consumer Price Index[a] (Percent change, year over year)							
Administration	4.0	3.8	3.7	3.2	2.7	2.2	1.7
CBO	4.0	4.9	4.9	4.6	4.4	4.4	4.4
GNP Deflator (Percent change, year over year)							
Administration	3.4	3.9	3.6	3.2	2.7	2.2	1.7
CBO	3.4	4.2	4.2	4.2	4.1	4.1	4.1
Three-Month Treasury Bill Rate (Percent)							
Administration	6.7	6.3	5.5	4.5	4.0	3.5	3.0
CBO	6.7	7.9	7.1	6.7	6.4	6.1	5.9
Ten-Year Government Note Rate (Percent)							
Administration	8.9	8.3	7.2	6.0	5.0	4.5	4.0
CBO	8.9	9.3	9.0	8.6	8.1	7.7	7.4
Unemployment Rate[b]							
Administration	5.4	5.2	5.1	5.0	5.0	5.0	5.0
CBO	5.5	5.5	5.5	5.5	5.6	5.6	5.6
Tax Bases							
Wage and salary disbursements							
Administration	2,434	2,605	2,780	2,969	3,159	3,342	3,515
CBO	2,435	2,615	2,787	2,969	3,163	3,370	3,590
Other personal income[c]							
Administration	1,618	1,721	1,853	1,955	2,043	2,119	2,204
CBO	1,626	1,754	1,870	1,977	2,090	2,211	2,346
Corporate profits[d]							
Administration	301	351	396	442	475	498	522
CBO	299	328	351	378	390	401	424

SOURCE: Congressional Budget Office; Office of Management and Budget.

a. Consumer Price Index for urban wage and clerical workers.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO projection is for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

c. Other personal income is personal income less wage and salary disbursements.

d. Corporate profits reported are book, not economic, profits.

The long-run assumptions of the Reagan Administration, on the other hand, are substantially more optimistic than recent experience would lead one to expect, especially in terms of their budgetary impact. The Administration assumes that unemployment during the 1991-1994 period will remain at 5 percent and that the economy will achieve an average growth rate of 3.2 percent per year. Despite this assumed rapid growth, the Administration projects that inflation will fall to less than 2 percent by 1994. Short-term interest rates are projected to drop to 3 percent in 1994 and long-term rates to 4 percent--lower than at any time since the early 1960s. While the combination of high real growth and low inflation in the Administration assumptions produces nominal incomes and tax revenues close to the CBO baseline, low inflation and low interest rates produce much lower federal outlays over the next five years than CBO projects. As with the short-term forecast, we believe that CBO's long-run economic assumptions provide a more prudent basis for making multiyear budget plans.

Chairman SASSER. The Congressional Budget Office's latest projections indicate that the Federal budget deficit will decline only slightly between now and 1994. There would be a deficit of $122 billion in 1994, using CBO's projections, if no action were taken by the Congress and the President before then.

In contrast, the administration assumes that even if no action is taken to reduce the deficit, the deficit will virtually disappear on its own by 1994. This is true even in 1990, when CBO projects a deficit of $141 billion, and the administration project a different deficit of $127 billion.

Mr. Blum, could you explain to the committee the key economic and technical differences between the Congressional Budget Office and the administration and how they affect the difference in your projections for the deficit in 1990 and the outyears?

Mr. BLUM. Yes, sir.

The differences in the economic assumptions account for almost all of the differences in these two budget projections. The administration's assumption of higher real growth and lower inflation does produce nominal incomes and therefore Federal revenues that actually are fairly close to the CBO baseline projections. And as Senator Domenici pointed out, our revenues in the near-term are actually higher than those estimated by the administration.

But the administration's assumptions of low inflation or low——

Chairman SASSER. What accounts for the fact that you are estimating higher revenues than the administration?

Mr. BLUM. It is because we have an assumption of higher levels of taxable incomes in our economy.

Chairman SASSER. Flowing from the 1986 tax reform bill?

Mr. BLUM. That partly explains it, but—Fred, is there anything you want to add to that?

Mr. RIBE. What Jim is referring to is the taxable shares of GNP. One has to talk about its division into wages, salaries, profits—the things that people actually pay taxes on.

We expect higher levels especially of the wage share, than the administration in the near-term. That is what the straight economics has to say.

Chairman SASSER. How much higher are you in revenues in 1990 than the administration?

Mr. BLUM. Well, in 1990, it is about $11 billion if we compare our baseline with the OMB current services. Expanding on Fred's comment, in addition to higher wages and salaries as a proportion of GNP, we also have higher estimates for other taxable incomes, stemming to some extent from higher interest rates—in other words, there is more interest income in our economy.

But to carry on with your first question, Mr. Chairman, while our revenue lines are fairly similar and well within the estimated error range for revenues, the administration's assumptions of lower inflation and lower interest rates really explain the difference, because they result in lower outlays.

And as a result, the difference in our outlay estimates grows from $19 billion in 1990 to $134 billion by 1994.

Chairman SASSER. Now, you have indicated, I think, in your testimony and perhaps in response to my question, that the administration is projecting much lower interest rates in the future than CBO.

In fact, the interest rates that the administration is projecting are lower than those that we are experiencing today, as I indicated in my opening statement. Now, suppose that interest rates remain at today's actual levels throughout your entire 5-year projection period. What would your projections of a deficit look like in that case?

Mr. BLUM. Well, that would have the effect essentially of keeping the deficit roughly where we think it is right now in the current year, close to $155 billion. It would keep the deficit at around $150 to $155 billion throughout the next 5 years.

Chairman SASSER. That is if we had T-bills going at 8.3 percent.

Mr. BLUM. That is correct. If interest rates continued flat at their present rate for the next 5 or 6 years, we would add $35 billion to the estimate for 1994, and I think this shows the power of the interest rate assumption on our budget projections. It picks up a point that Senator Sanford was making in terms of the large volume of Federal debt that has been accumulated over time, which of course drives these debt service costs.

Chairman SASSER. President Reagan has proposed in his budget some policy changes and asset sales. The President estimates that the administration's budget proposals excluding asset sales would lead to a deficit of $99 billion in 1990 using the OMB economic and technical assumptions. There would be a small surplus of about $2 billion in 1993. That is the year the budget is supposed to be balanced under Gramm-Rudman-Hollings.

Now, I know CBO has been working on reestimating the President's proposed budget, using CBO economic and technical assumptions. What would happen if you used CBO's economic and technical assumptions; what would be the deficits in 1990 and 1993, if you just used the administration's policy changes and you plugged into those policy changes CBO's economic and technical assumptions?

Mr. BLUM. Well, a short answer to that, Mr. Chairman, would be simply to add the differences between our current service and the baseline deficit projections to the administration's deficit projections. But we will, as you indicated, come up with our own reestimate of the President's budget. We are hard at work at doing that right now, and I cannot this morning tell you exactly where our technical re-estimates would fall out. I am sure we will have some differences with the administration's estimates.

But I can indicate something about what would happen, by just substituting the CBO economic assumptions for the administration's——

Chairman SASSER. Well, substituting CBO's economic assumptions for the administration's economic assumptions, and taking the administration's policy changes, what would be the deficit in 1990?

Mr. BLUM. Excluding asset sales would raise the deficit estimate for 1990 to $110 billion, by 1993, when under the Gramm-Rudman-Hollings target we are to have a balanced budget, it would produce a deficit of $83 billion.

Chairman SASSER. So using those assumptions, using CBO assumptions, and the administration's policy changes, in 1990 you would miss the Gramm-Rudman-Hollings target of $100 billion, but you would hit the $110 billion wiggle room target?

Mr. **Blum**. Right, just.

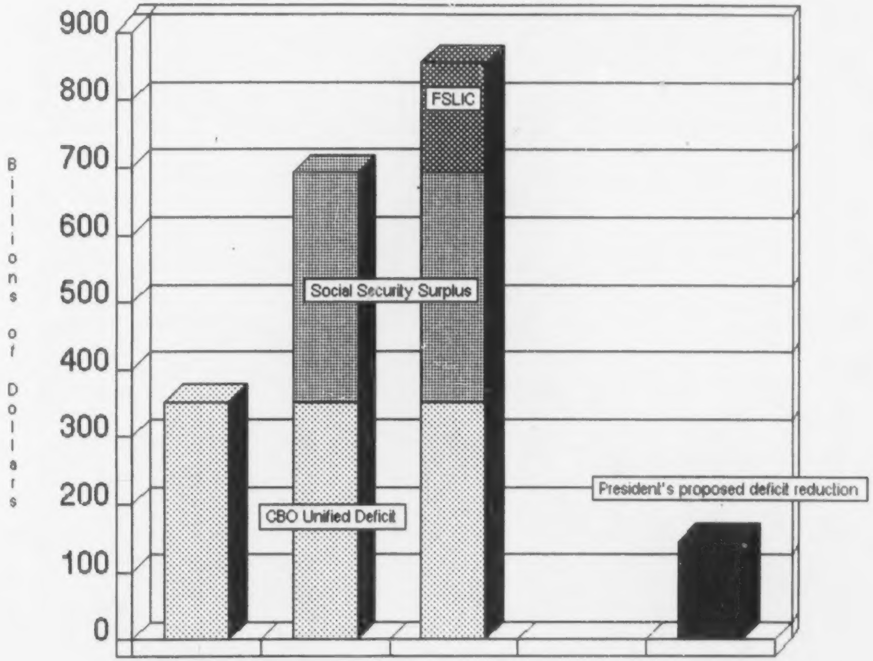
Chairman **Sasser**. All right. I want to focus now on the total amount of deficit reduction we will need in the next 4 years in order to meet the Gramm-Rudman-Hollings targets, and then I am going to yield to my distinguished colleague, Senator Domenici.

We have a chart here which will help to clarify this situation. [See chart 4.] The first bar on the chart shows that $353 billion of deficit reduction will be needed to meet the Gramm-Rudman-Hollings targets according to CBO projections.

CHART 4

Magnitude of the Deficit Problem

1990 – 1993



Senate Budget Committee Staff
January 1989

Is that your understanding, Mr. Blum?

Mr. BLUM. Yes, Mr. Chairman. That first bar is simply the summation of the differences between our baseline deficits and the Gramm-Rudman-Hollings deficit targets for those 4 years.

Chairman SASSER. Right. Now, under Gramm-Rudman-Hollings rules, the social security surpluses are counted as reducing the deficit. Some people believe that these social security surpluses are masking the true size of the deficit in the rest of the budget.

Now, suppose for the moment that we did not count the social security surpluses. Wouldn't that add another $340 billion to our deficit reduction problems, as shown in bar 2 there?

Mr. BLUM. That is correct, Mr. Chairman. Essentially, what that shows is the 4-year sum of the off-budget surpluses that we have projected, as laid out in table 3 in the statement.

Chairman SASSER. Now, let us consider the costs associated with the savings and loan crisis. What if a bailout for FSLIC were constructed on-budget over the next 4 years, which assumes a $100 billion net present value for the cost—and that is what some are saying it is going to cost us, $100 billion. Understand, I am not necessarily advocating that particular solution, but I think it may help to identify the magnitude of the potential problem.

Mr. Blum, in total over the 4-year period, approximately how much more would this FSLIC cost add to the deficits already shown in bars 1 and 2?

Mr. BLUM. The size of the bar indicates a lot. Mr. Chairman, we have not ourselves come up with a specific figure, but using your example in a hypothetical way of $100 billion net present value in addition to that which we already have in our baseline projections, I think that would translate into an annual budget impact of roughly $30 billion to $40 billion a year if this were done all on-budget. This assumes also that an effort would be made to liquidate a lot of these failed S and Ls, so a lot of up-front cash would be needed to do that. That could give you a 4-year total clearly in excess of $100 billion, probably in the $130 billion to $150 billion range.

Chairman SASSER. Well, what I am trying to get at here, and the point I am trying to make, is that we could be looking at an aggregate deficit problem of about $800 billion between 1990 and 1993 if we use CBO assumptions, which most would concede have more validity than those of OMB. If we strip away the social security surpluses, that is a due bill that is going to come due at some point in the future, and if we crank in there the FSLIC problem, using some of the numbers that are presently being accepted as having some validity, we are looking at an $800 billion deficit reduction problem. We have not even talked about other things that we may have to deal with: nuclear clean-up; the funds that may be needed to renew the subsidized housing contracts that I am advised are about to expire; authorized funding levels for the drug bill that we passed last year; the space station; and the super collider, that I happen to think are important.

This chart indicates magnitude of the deficit problem using CBO deficit numbers from 1990 to 1993 combined with the social security surplus being subtracted from the general operating fund of the Government, adding onto that the FSLIC problem, we came up with a figure of somewhere in the neighborhood of $800 billion in deficit problems between 1990 and 1993, if I am not mistaken; is that correct, Mr. Blum?

Mr. Blum. Yes, sir.

Chairman Sasser. Then, we see at the far right of that chart a little, orange bar, which is identified as the President's proposed deficit reduction for the years 1990 through 1993. What does that amount to, do you know?

Mr. Blum. Well, taking the figures in the administration's budget for changes from the OMB current services projections, that would sum to $146 billion over the 4-year period.

Chairman. Sasser. So what we've got is a $146 billion solution proposed by the administration to what could be an $800 billion problem between 1990 and 1993. Is that a fair statement?

Mr. Blum. Well——

Chairman. Sasser. Well, let me rephrase that. You don't have to make that value judgment. What I am saying here is that we have got $146 billion in deficit reduction proposed by the administration, whereas CBO, using a combination of CBO projected deficits, the FSLIC problem, and subtracting social security surpluses, we could have an $800 billion deficit problem.

Mr. Blum. That is correct, Mr. Chairman. I would observe that the $146 billion, through, is probably best compared to the red bars, that is, to the difference between our baseline deficit projections and the Gramm-Rudman-Hollings deficit targets. The administration is not proposing during the next 4 years to run a surplus of the size indicated by the Social Security Trust Fund, nor was it yet come up with a specific plan for solving the savings and loan problem.

Mr. Sasser. Let me now turn to Senator Domenici for his questions.

Senator Domenici. Thank you very much, Mr. Chairman.

Let me first say to the members that are here, I am going to try very hard to be brief in my questions, because I assume you are remaining here because you have questions of your own.

Mr. Blum, let me ask you this. With reference to the 1990 budget, yours versus President Reagan's, do I understand correctly that a comparison of those two budgets would indicate that you have $11 billion more in receipts using your economic assumptions, which provide for less economic growth than the President's? We commonly call those taxes or revenues. Is that correct?

Mr. Blum. Yes, sir.

Senator Domenici. And in your overall budget, you have interest costs, which are roughly $13 billion more than OMB's in behalf of the President; is that right?

Mr. Blum. Yes.

Senator Domenici. It appears that CBO projects outlays for FSLIC deposit insurance as $7 billion higher than the President's budget.

Mr. Blum. That is correct.

Senator Domenici. And that is no new program to bail anybody out; that is what you assume the on-budget outlay estimate is, and OMB assumes an outlay estimate, and the difference is $7 billion.

Mr. Blum. That is correct.

Senator DOMENICI. Defense. You do the best you can, they do the best they can, with a programmatic or budget authority assessment, and both of you try to estimate the amount of outlays that will flow from that cumulative programmatic allowance. And there, again, the difference is $5 billion; is that correct—$5 billion in outlays, more or less?

Mr. BLUM. More or less, yes.

Senator DOMENICI. Yes; and the only other difference that I can find is FDIC, again with the same parameters that I have given before—this does not assume major policy changes in the law, but rather outlay assumptions. You have a difference there of $3 billion. If you add them up, you get $15 billion, which is essentially the $126 billion deficit the administration estimates minus the $141 billion that CBO estimates. And almost all of that difference is made up of FSLIC, FDIC, and defense, because interest and revenues almost wash in terms of you being higher on one and lower on another. Is that somewhat accurate?

Mr. BLUM. Oh, yes, sir. That is a correct analysis.

Senator DOMENICI. Does that lead us to a conclusion that as between you and OMB, that we are really talking about technical assessment differences rather than macroeconomic differences as we attempt to——

Mr. BLUM. Well, once you strip out the revenue difference and the difference in interest rates, that is true. There are important differences on inflation assumptions as well, in the sense that we do have a higher inflation rate affecting the 1990 budget than the administration has. I think if we were to look at that only, that is roughly a $5 billion difference.

I think that of the $11 billion difference in revenues, we would attribute about $6 billion to the differences in economic assumptions and $5 billion to the technical differences.

But you are right, Senator, you have identified the major differences. There are different ways of adding the pieces up and contrasting them, but essentially you are looking at fairly major technical estimating differences.

Senator DOMENICI. Let me ask you, in your economic assessments for the economic well-being of this country, when you speak of inflation, you obviously cause some people to immediately look at the independent entity out there called the Federal Reserve, which has something to do, I believe—even though they continue to say they do not—with what the interest rates are in this country, and therefore, how much we might grow or not grow.

What do you assume in your CBO economic assumptions with reference to the Federal Reserve Board's policies? Do you assume anything?

Mr. BLUM. Well, we are assuming that the Federal Reserve Board will continue to push against the strong economic growth that we have had in our economy in order to bring it down to a more sustainable rate, which is essentially the trend rate of growth.

This starts from the premise that the economy now is operating almost at, or approximately at, full capacity. When this occurs over an extended period of time, inflationary pressures do build up. We take the Federal Reserve Board at its word that it will act to restrain those inflationary pressures largely through pushing up interest rates.

Senator DOMENICI. So that instead of accusing OMB of trying to make life easy for budgeteers or painting a rosy scenario, we could almost conclude that in a bona fide manner, that OMB assumed the Federal Reserve Board therefore would be more generous in their monetary policies. That might account for the disparity in growth between your set of economic assumptions and theirs.

Mr. BLUM. Yes, that is essentially correct. I think the administration's economic forecast is implicitly, if not explicitly, based on an assumption of a higher potential growth rate, brought about through higher growth in productivity than we have actually been witnessing recently.

I think the problem that I see in the administration's economic assumptions is not with any particular variable in isolation, but with the sum of them. And I think they are optimistic in adding up all of the variables—higher growth, lower inflation, and lower interest rates—and thus getting a very optimistic picture for the budget.

Senator DOMENICI. The last question, Mr. Chairman, may lead to a request that some chart be prepared for our consideration. You have a revenue increase attributable to natural growth in the tax base, which I gather is somewhere around $86 billion. That is an automatic increase without changing current tax policy.

Mr. BLUM. That is correct.

Senator DOMENICI. Year over year, we will have that much more in revenues in the coffers of our country.

Mr. BLUM. That is the projected increase for fiscal 1990 revenues over the current year 1989.

Senator DOMENICI. Now, the CBO baseline, which Senator Gramm was talking about, adds $71 billion on the expenditure side as an automatic increase in the budget. When we speak of cutting from the baseline, we sometimes confuse ourselves and think we are cutting in absolute terms over the year before; we are actually cutting from a $71 billion increase if we reduce your baseline. Is that correct?

Mr. BLUM. That is correct.

Senator DOMENICI. And could you furnish us—not now, but for the perusal of the members—with a list of the big items that will go up, year over year, how much, what percent, that you include in your baseline—would you do that for us?

Mr. BLUM. We would be happy to do so.

Senator DOMENICI. Like defense, discretionary accounts, medical expenditures, medicare, et cetera—give us those kinds of items, year over year. And could you do it for the 5-year cycle, line-by-line?

Mr. BLUM. Yes. My staff must have anticipated that question. I have such a table in my briefing book.

Senator DOMENICI. Do you? Mr. Chairman, do you mind if he submits it now?

Chairman SASSER. No; that would be fine.

Senator DOMENICI. I think you gave it to the National Economic Commission, and therefore it probably is presumed to be relevant by your staff.

Mr. BLUM. Yes. [Laughter.]

If I may summarize it—this is a copy for the record.

Senator DOMENICI. Thank you.

[The following table was submitted for the record:]

COMPONENTS OF CBO BASELINE SPENDING PROJECTIONS (By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994
1989 Level	1,138	1,138	1,138	1,138	1,138
Current Law Increases					
COLAs for entitlement programs	13	29	45	61	77
Increases in entitlement program caseloads	8	16	25	33	42
Increases in costs of medical care	5	10	17	25	34
Increases in use of medical care	12	22	30	40	50
Rising benefits for new Social Security beneficiaries	4	6	9	12	16
Expected changes in offsetting receipts and asset sales	0	-3	-7	-10	-14
Increased interest costs	13	24	29	35	38
Other	6	10	8	7	8
Subtotal	61	114	157	202	250
Inflation Adjustments to Maintain Real Spending for Discretionary Programs					
Defense purchases	4	10	17	25	34
Defense pay	3	8	13	18	23
Nondefense purchases	3	8	14	20	27
Nondefense pay	1	3	5	7	9
Subtotal	11	29	49	70	92
CBO Baseline	1,209	1,280	1,344	1,410	1,480

SOURCE: Congressional Budget Office.

Mr. Blum. If I may summarize it, the cost-of-living adjustments for entitlement programs account for a large portion of these increases in projected outlays. For 1990, the additional add-on in outlays would be $13 billion, and by 1994 that rises to $77 billion.

There are a number of other factors such as increases in entitlement program caseloads from an $8 billion increase in 1990 to $42 billion by 1994. We have broken this out into a number of such relevant pieces, and I think this is instructive.

Senator Domenici. Mr. Chairman, let me just suggest that if that is what they gave, it is going to have a rather startling number. The increased medical services and medical inflation above CPI in that baseline is the largest item increase in the budget. It is $17 billion, if I have the correct chart. Is that what your chart shows? Twenty-four percent of the baseline increase is attributed to medical costs above CPI.

Mr. Blum. Seventeen billion, yes, sir. That is the increase in the costs of medical care, which is partly in prices but also includes increases in the utilization of medical services.

Senator Domenici. Thank you, Mr. Chairman.

Chairman Sasser. Thank you, Senator Domenici.

Senator Conrad.

Senator Conrad. Thank you, Mr. Chairman.

If we could go back, Mr. Blum, to the economics and not just concentrate on this year. I think we should look at the outyears as well, because it is the outyear estimates that show the pattern the administration has suggested, that the combined budget deficit, including the social security surpluses, virtually evaporates under their assumptions. I would like to direct your attention to the interest rate portion of the estimates and ask you to characterize OMB's forecast for interest rates through 1994.

I notice that OMB projects a steady decline in interest rates down to 3 percent in 1994, on a 3-month T-bill rate. Your estimate is 5.9 percent. The *Blue Chip* is at 6.5 percent.

In your professional judgment, would you characterize that as a rosy judgment? Overly optimistic? How would you characterize their interest rate projections?

Mr. Blum. I would make several comments. First of all, if you strip away the effect of inflation and look at the real interest rate, the differences in our assumptions are not that great. The lower nominal interest rates that you mention result from the lower inflation rates assumed in the administration's budget.

Senator Conrad. What are their real interest rate assumptions, and what are your real interest rate assumptions?

Mr. Blum. Well, I think they come down to roughly in the range of 1.5 to 2 percent in real terms, by 1994.

Senator Conrad. Which has historically been the case.

Mr. Blum. Which, if you go back to 1973, for example, when exchange rates were allowed to float, is roughly what prevailed at that time.

Now, another comment that I would make is that our longer-run assumptions are based on historical trends, whereas I think the administration assumes that we can do better than that, particularly for productivity growth. Higher productivity growth would increase economic growth and also could produce lower inflation.

I do not know whether one can characterize that as being overly optimistic or not. Economists do not know a whole lot about what is causing productivity growth to behave the way it has in the last couple of decades. I think I would characterize the CBO assumptions as perhaps more prudent, because the effect of the administration's assumptions, taken in combination, is to produce a much more optimistic budget outlook.

Senator CONRAD. There really is a very dramatic difference between not only OMB and CBO in those outyears, but also OMB and the *Blue Chip*.

Mr. Chairman, the trade numbers were out this morning showing a dramatic increase for the month of November. Much of the strength of the economy that we saw last year was attributed to more favorable trade balance. With these numbers slipping and many forecasters now indicating they do not anticipate that kind of increase or improvement in the trade balance, could you tell us what effect that might have over the next several years if that trend continued?

In other words, if the trade balance were static, if we were not getting the kind of improvement we got last year, what kind of effect would that have on the projections that are before us?

Mr. BLUM. Our forecast for the next 2 years assumes that the amount of growth coming from real net exports will be less than it was in 1988. While the figures that were released this morning can, I think, be characterized as disappointing, they are consistent with the lack of improvement over the recent 6-month period in net exports. In our forecast we are looking for some improvement in real net exports as one of the sources of growth; if that does not materialize, then the effect on our forecast presumably will be lower growth than we have projected.

Senator CONRAD. Even lower growth.

Mr. BLUM. Even lower growth.

Senator CONRAD. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Conrad.

Senator Sanford.

Senator SANFORD. Thank you, Mr. Chairman.

Mr. Blum, I think you have done a very good job of projecting the future. It is a very difficult job. I think the record of the Congressional Budget Office is that over the years, they have come closer to being accurate than other projections available to us. And we are now sitting here, talking about this baseline and that baseline and this projection and that projection. You are projecting the numbers the way the law requires. I want to ask a more philosophical question. What difference does it make whether we have a deficit or not?

Chairman SASSER. I think that is an excellent question, Senator.

Mr. BLUM. Continuing high deficits mean that the Federal Government is dissaving. The Federal Government is, to a large extent, responsible for the fall in national saving that we have experienced over the last decade. The individual saving rate has also fallen as well, so between the two of them——

Senator SANFORD. How does that relate to the deficit?

Mr. **Blum**. Well, the deficit represents negative saving. It means that we are consuming as a nation much more than we have in the past, and that——

Senator **Sanford**. Well, that is just a little bit of money, though, compared to the size of the budget, and it is getting smaller all the time, so what difference does it make?

Mr. **Blum**. It means that we are not setting aside enough in the way of saving and investment for future economic growth, so we are consuming now at the expense of future generations. That is one consequence of the deficit.

A second outcome is that interest rates are higher than they otherwise would be if we were not running these relatively high budget deficits.

A third outcome is that the budget deficits are largely responsible for the trade deficits that we are having, and we are building up a risk of subjecting the economy to outside pressures. To the extent that our domestic investment relies increasingly on foreign capital, we are subjecting ourselves to the whims of foreign investors.

Senator **Sanford**. Well, now, our deficit is not really paid for by foreign capital, not any one year's deficit.

Mr. **Blum**. What has happened is that national saving has fallen much more than has net investment. The difference is made up by the inflow of capital from abroad. To that extent, our rate of investment has been maintained by this foreign capital.

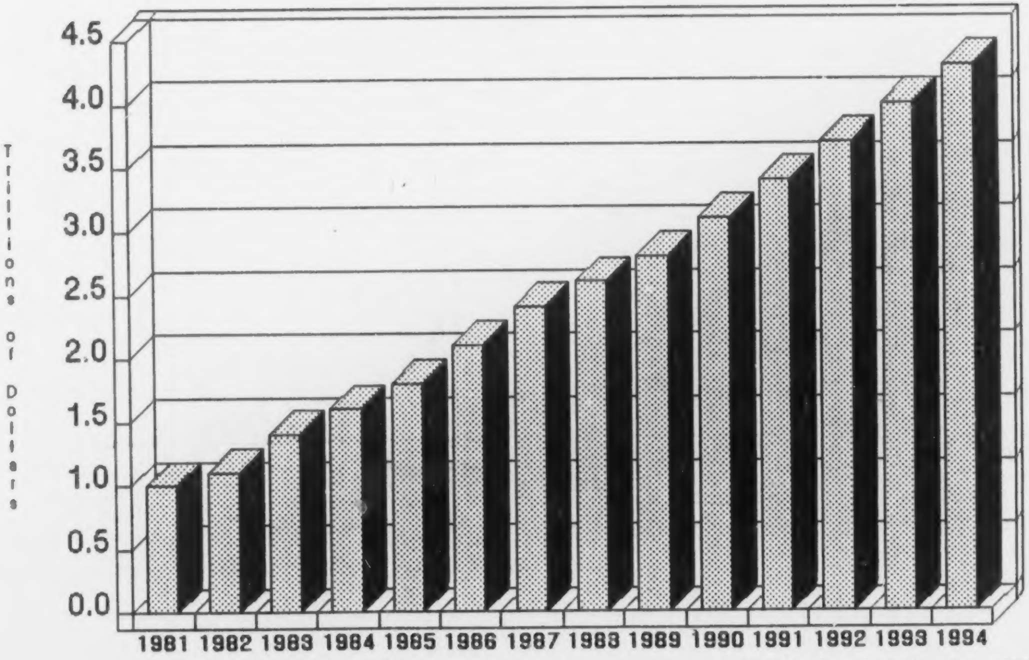
Senator **Sanford**. Well, I take it that you are saying that it is not the deficit in any one year, but it is the accumulation of deficits or the debt that causes all of these dire results?

Mr. **Blum**. That is exactly right.

Senator **Sanford**. That, then, brings me to the question of are we not sitting here, going through a needless exercise of sounding reveille on the bugle, while the bugler is standing there, getting deeper and deeper in quicksand all the time. We talk about bringing this deficit under control, reducing this deficit—yet we have a chart showing from 1981 a debt at less than $1 trillion to 1994—and I am sure this is conservatively estimated—of well over $4 trillion. [See chart 5.]

CHART 5

Quadrupling of the Federal Debt:
1981 — 1994



Source: OMB and CBO data Fiscal Year Senate Budget Committee Staff January 1989

What we are talking about—the baseline deficits and the GRH targets—is not realistic. The problem is not the deficit, but the debt, because the debt continues to rise. The gross Federal debt continues to increase. We owe all of this money, and we will be paying interest on all of this money. Aren't we just spinning our wheels? We are not really reducing the debt or the deficit.

Mr. **Blum**. Well, it is true that the debt continues to grow in nominal terms. But there is a lot of controversy, I think, as to exactly what that means for the economy.

I would observe that this chart looks at Federal debt in gross terms, which includes the Government securities that are issued to the various trust funds.

Senator **Sanford**. But the reality, is it not, is that we owe that money. The reality has demonstrated that we owe that money because the debt limit is set at gross national debt, and we are going to have to increase the debt limit soon. Debt is debt and causing all of the problems, and we are not solving the problem, are we?

Mr. **Blum**. Well, that is correct. But I would characterize this debt that is issued to the Government trust funds as essentially IOUs, although they do represent amounts of money that are going to have to be paid out in the future for retirement benefits and for other purposes.

But from the point of view of the economic impact of the debt, a more useful measure, economists will say, is the amount of debt held by the public. That, too, is growing. Right now, we are at the $2 trillion level, and by 1994 it will approach $2.9 trillion, under our projections.

Relative to GNP, however, that actually represents a small decline. So that has led some observers to argue that that is not——

Senator **Sanford**. I know they argue that, but my question to you is that is not much of an argument, is it?

Mr. **Blum**. Well, again, it goes back to the point that you made, Senator, about accumulation over a long period of time. If you look at it in any one year, we clearly are not in a crisis situation. As it adds up over time, however, I think there is more cause for concern.

Senator **Sanford**. Thank you. My time is up.

Chairman **Sasser**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

How much has the operational side of the Government now borrowed from the Social Security Trust Fund?

Mr. **Blum**. In total?

Senator **Riegle**. Yes. What would be the outstanding borrowings today from social security?

Mr. **Blum**. I do not have that figure with me, but I would be glad to supply that.

Senator **Riegle**. Well, can you give me an approximation? Would it be in the tens of billions?

Mr. **Blum**. Yes, sir.

Senator **Riegle**. Is there somebody here who can give us a rough estimate?

Mr. **Blum**. I would say about $100 billion, probably.

Senator **Riegle**. $100 billion is probably a reasonable estimate?

Mr. **Blum**. Yes, give or take.

Senator RIEGLE. Now, if the Government has been borrowing from the Social Security Fund, what has the Government been doing with the money?

Mr. BLUM. It has been used to finance other Government expenditures.

Senator RIEGLE. So it has been used to finance other Government expenditures.

Now, when you look at what constitutes that package of other Government expenditures, most of those expenditures are what we would call operating expenses, day-to-day bill-paying, would it not be? In other words, most of that spending would not go to the creation of an income-earning asset.

Mr. BLUM. That is correct.

Senator RIEGLE. So we are borrowing from the Social Security Trust Fund, and we are spending the money we borrow for the day-to-day operations of the Government, for the most part.

Now, in the future, when that money has to be paid back to the Social Security Fund, the money that has been borrowed, where will that money come from?

Mr. BLUM. Well, it will come either from increased revenues or reduced operating expenditures.

Senator RIEGLE. But in order to have the money, it has got to be revenue first. I mean, there has to be revenue coming into the Government; if there is no revenue coming in, you cannot pay it back, presumably.

Mr. BLUM. Well, that is correct. But what will happen over time is that the social security benefit costs, with the retirement of the baby boom generation, will grow dramatically.

Senator RIEGLE. Well, who is going to have to provide the money to pay back the social security borrowings? Isn't it essentially the taxpayers of the country?

Mr. BLUM. Oh, absolutely. The real burden at that time will be on the people who are working.

Senator RIEGLE. Yes. Well, how do you think people are going to feel who have been paying into social security over the years, whatever their age, to build up this trust fund so it is there later on for their retirement, when they finally figure out that what has happened has been that that money has been loaned to the Federal Government. The Federal Government has spent it on day-to-day expenses, and when it comes time to pay the money out, the taxpayer is going to have to contribute, in effect, a second time to the Government so the Government can pay back the Social Security Fund, so benefits under social security can actually be paid.

Now, I do not think the public yet understands that that kind of a game is going on, but that is what is happening, and it is happening in very large amounts.

Now, am I correct in recalling that a moment ago, you said you thought the outstanding borrowings from social security were about $100 billion?

Mr. BLUM. Yes, sir.

Senator RIEGLE. To me, that is a very important fact. Now, that $100 billion should be invested in income-producing assets. For example, if you take an IRA or you invest money in the stock market, or you invest it in a building or in an apartment that you are going to rent, you are investing in something that presumably produces a stream of income so that you not only have the dollar value of the investment, but you have earning power generated by the investment. It seems to me that what is happening here, quite apart from the accounting tricks that we use to hide the real size of the deficit by using the social security surpluses as an offset is that we are actually spending the social security surplus. The money is being consumed, it is disappearing, and it is creating a future claim that is going to fall right back on the person who put the money in to create the social security surplus in the first place.

I think when the taxpayers of this country figure out that their money is being withdrawn from the social security account and being spent for other things—not for social security, but for other operations of the Government—they are going to be very angry about it, and they have a right to be.

And it seems to me that we are failing to understand the true cost of the Government today and how we are financing it; in effect we are drawing down the value and the money that is actually in the Social Security Fund.

I want to talk with the chairman and the other members of the committee as we go along as to how we deal with this, because it is a two dimensional problem. One dimension is that the trust fund surpluses make the deficit look lower than it really is—it is closer to $250 billion than $150 billion a year. Secondly, Mr. Chairman, the social security surplus funds are being borrowed and spent, and they are disappearing; they are disappearing every single day. We are going to have to come up with a better answer than the kind of shell game that we have been engaging in for the last several years.

Before 1983, we were not running a large surplus in social security that had to be set aside for the future. Now, we are. But we are spending that surplus. We are spending it every single day, and I think that is wrong.

Chairman Sasser. Thank you, Senator Riegle.

I might add that one of our colleagues here, a little earlier in the course of these hearings, indicated that revenues were growing, would grow in fiscal year 1990 by about $86 billion a year. What he did not indicate was of that $86 billion about $30 billion of that revenue growth was in social security funds that are turned around and borrowed by the Government for other functions. There is an obligation later for those social security funds to be used to pay benefits.

So to say that revenues are growing by more than $80 billion, when nearly $30 billion of that are earmarked social security funds, is an illusory revenue gain.

Senator Riegle. I thank the chairman.

Chairman Sasser. Thank you, Senator Riegle.

Now, moving rapidly here, Mr. Blum, according to the President's budget, or using his OMB numbers, we have a deficit projected for 1990 of $127 billion. This is the administration's deficit projection.

Now, if there were no deficit reduction before next October, a sequester then would take place, because it is $27 billion above Gramm-Rudman-Hollings target if no changes are made. If the

President exempted military personnel from cuts, an across-the-board cut of 11.2 percent would occur in defense programs pursuant to Gramm-Rudman-Hollings. Similarly, an across-the-board reduction of 9.8 percent would occur in nondefense programs.

Now, CBO estimates, of course, as you stated earlier, that their deficit would be $14 billion higher than that of OMB, using CBO figures.

If we started with CBO's deficit of $141 billion, a larger sequester obviously would take place.

Now, my question to you is if you use CBO's $141 billion deficit number, and if you exempted military personnel from the strictures of Gramm-Rudman-Hollings, what would CBO estimate the across-the-board percent reduction to be for defense programs?

Mr. BLUM. Well, you are right, Mr. Chairman, it would be much larger by our calculations; instead of 11.2 percent, it would be on the order of 17 percent.

Chairman SASSER. So, if CBO's deficit projections are correct, there will be a 17-percent reduction in defense programs. How much would that amount to in outlay reductions, and what about budget authority?

Mr. BLUM. Well, the outlay reduction is simply half of the difference between 41 and 0, so a little over $20 billion would have to be taken out of the defense side of the budget.

Chairman SASSER. And would the budget authority run to about $60 billion?

Mr. BLUM. Well, it would not be that much, but it would be—including the new budget authority as well as unobligated balances, it would run up to $46 billion.

Chairman SASSER. Well, could you give us some examples of broad impacts that this would have in certain areas of the defense budget?

Mr. BLUM. Well, in terms of the levels of budgetary resources that would have to be extinguished or sequestered, the heaviest-hit by exempting military personnel would be the procurement accounts.

Chairman SASSER. Procurement accounts?

Mr. BLUM. Procurement accounts for the purchase of major weapons systems. Of the $46 billion that would be sequestered, $20 billion would be in the procurement accounts; another $15 billion would be from the operations and maintenance accounts, which just keeps the services in a state of readiness; research and development would be cut by $7 billion.

Chairman SASSER. What would be the percentage cut in domestic programs?

Mr. BLUM. That would be almost as high as defense. It would be, under our calculations, 15.8 percent as an across-the-board sequestration.

Chairman SASSER. Give us an example of the broad impacts this would have on certain domestic programs.

Mr. BLUM. Remembering that a great deal of the nondefense budget is in fact exempt from the sequestration process, it really hits very heavily on the nondefense discretionary programs, so that, for example, budget authority for education programs would be reduced close to $3 billion under a sequester of that size. The

Public Health Service would take a $2 billion reduction in budgetary resources; law enforcement, almost $2 billion.

So these are very large numbers, obviously.

Chairman SASSER. Let me get through a couple more questions, and then I want to defer to Senator Domenici.

Could you tell us what the trend is in both the public and private savings rates in recent years in the United States?

Mr. BLUM. Yes; as I indicated earlier, both the public and the private saving rates during the 1980s have been well below historical averages. If we take the sum of net private saving and public saving, it has fallen from an average of about 8 percent of net national product in the 1950s, 1960s and 1970s, to only 3.7 percent in the 1980s, a fall of more than 50 percent.

The public and private shares have contributed about equally to that fall.

Chairman SASSER. And what have been the combined impact of the trends in both public and private savings on national savings?

Mr. BLUM. Well, they have both contributed about equally. There have been some improvements recently in public saving, but it is about an equal contribution.

Chairman SASSER. Are these public savings taking place in local and State governments?

Mr. BLUM. Well, it is a combination of Federal Government and the State and local governments. The Federal Government obviously has been running deficits; the State and local governments, when we add in their pension funds, have in effect been net savers or have been running a surplus, although their operating budgets have been in deficit in recent years.

Chairman SASSER. I want to defer now to Senator Domenici.

Senator DOMENICI. Your last assessment leads me to ask—Why do we continue to argue about whether or not the accumulated Social Security Trust Fund is a savings—isn't it?

Mr. BLUM. Well, it is savings of sorts, but——

Senator DOMENICI. Well, wait, now. If the pension fund is, the pension fund has to pay out at some point, doesn't it? We do not have a pension fund there without an obligation; it is there to pay pensions out. I assume the Social Security Trust Fund surplus is there to pay out to beneficiaries at a point in time.

Mr. BLUM. Well, it represents essentially an accumulation of budget authority that would be used or drawn down in future years as the baby boom generation retires and as the amount needed for social security benefits goes up. But what I was just discussing, in terms of net public and private saving, is a little different.

The critical ingredient in that equation is unified budget, which adds in the social security surpluses on the one hand with the on-budget deficits on the other, to arrive at a net figure; and it is the net figure that goes into this national saving equation.

Senator DOMENICI. Frankly, I really am not trying to be argumentative with anyone; I am trying to learn what it is, because we have never had such a thing. I mean, social security from its inception has never had surpluses like this. We had small ones, but for most of its life, it survived month-to-month. We Social Security even borrowed for a number of years, from medicare, when it was solvent, to pay benefits, and then it borrowed from the general fund. Now we have these taxes paid that are being accumulated in very large amounts, because we figured the demographics and other things right, and the economy stayed healthy for a long period of time, making this the case.

I really do not know what it means when the surplus builds to a trillion dollars vis-a-vis the national debt; I do not know what it means versus national savings requirements for capital formation. Some say it is a big plus on the capital formation side. If the surplus wipes out the national debt, then capital formation occurs because private money is not necessary to finance the national debt.

So I really do not know what it is, but surely, it counts for something when you do not need it for 15 or 20 years. It is part of the net accumulated assets of the country that are available for something. We should not just let it sit there, should we? Somebody said why are we borrowing it. Well, how do we make money if we do not lend it to somebody?

Mr. BLUM. Well, I think the critical thing is the total budget situation. If we run a balanced budget on a total basis from the latter half of the 1990s into the 21st century, the total will comprise large surpluses in the social security funds for a while, as well as deficits in the rest of the budget.

But from the point of view of the difference it makes to national saving, it is the total that makes the difference.

Now, what the realization of these social security surpluses has done is call attention to the fact that it could make sense for longer-run fiscal policy to run surpluses in the unified budget, thus increasing national savings and therefore having higher levels of investment. That would increase economic growth and the size of the economic pie that will be there when the baby boom generation retires. The burden on the people who will be working then—and mind you, relative to the labor force that we have now, it will be a smaller segment of the population—that burden will be less than it would be otherwise.

I think that is the important point.

Senator DOMENICI. Well, without knowing what it really is, I would say that I have arrived at the conclusion—that at the end of the Gramm-Rudman cycle that we ought to start taking it off-budget so that we do begin to start not counting it in a Gramm-Rudman way. It is already off-budget; we just permit the surplus to be counted for the Gramm-Rudman deficit targets.

I believe we ought to start taking it off in all respects, piecemeal, so that we have to create a surplus on-budget. At a point in time, the surplus should be equal to the amount in the trust fund, whatever the amount is, at some point before we need it.

Mr. BLUM. Well, it might be a coincidence if the appropriate amount of surplus for the Federal Government as a whole happened to match that of the social security surplus. But nonetheless, many would argue that over the longer run, the Federal Government ought to be running a surplus rather than having a balanced budget or at least the deficits that we are experiencing now.

Senator DOMENICI. Well, let me get back to the sequester and the practical effects of us getting into a hiatus up here, where we cannot solve anything, and we cannot accommodate the Vice President and the President-elect, and we have a sequester.

On page 4 of your statement, just before that new paragraph where you say "Changes Since August" you say, "In President Reagan's 1990 budget, OMB estimated," et cetera. You have these words: "ignoring statutory limitations on spendout rates, if OMB comes up with a similar estimate this summer, only $16 billion in deficit reduction will be required to avoid sequester."

What does "ignoring statutory limitations on spendout rates" mean? Does that mean the $16 billion would actually be less, and if so, how much?

Mr. BLUM. In fact it would be less. It would be almost $4 billion less.

What this refers to is an adjustment that OMB has to make in order to prevent changes in the spendout rates for defense or nondefense programs from changing by more than 0.5 percentage points.

Last year, you will remember, during the late summer and early fall, OMB made similar adjustments in their baseline projections, except that that time the adjustment factor actually added to the deficit.

According to the special analysis that accompanied the President's budget for 1990, the adjustment factors would go the other way. For defense programs, for example, they would have to lower their Gramm-Rudman-Hollings baseline number in August, if everything stayed the same, by $4.1 billion, because of this constraint, and they would raise the nondefense programs by $0.4 billion, for a net reduction of $3.7 billion. So you could take $3.7 billion away from the $126.1 billion that was given in the President's budget as their sequester estimate right now, producing a baseline deficit of only $122.4 billion.

Senator DOMENICI. Let's see one twenty-two point four, reduced by the $10 billion float, when the sequester time arrives, assuming the same economics; we are now talking about a sequester of $12.4 billion; is that correct?

Mr. BLUM. As measured by the Office of Management and Budget, that is correct. And I point out that, of course, under Gramm-Rudman-Hollings, their numbers are the ones that count.

Senator DOMENICI. Oh, it sequesters all the way to $100 billion, but——

Mr. BLUM. Oh, that is true, yes.

Senator DOMENICI [continuing]. But in order to avoid it——

Mr. BLUM. To avoid sequester, because of the $10 billion leeway, you would have to reduce the deficit in excess of the $12.4 billion.

Senator DOMENICI. So, Mr. Chairman, as I understand this—and you correct me again, if I am wrong—OK we get into a confrontation and can get nothing done, since the statute law under Gramm-Rudman-Hollings II says OMB does all of the economic assumptions, and OMB does all of the technical assessing, we have an effective sequester that could be imposed instead of a deficit reduction plan, of $12.4 billion to get to the targets.

Mr. BLUM. Well, no. Actually, the sequester would be $22.4 billion because you go all the way to zero, but to avoid a sequester, you would only need to have deficit reductions——

Senator **Domenici**. So that we have an opportunity to get this done if we want to, with $12.4 billion in deficit reduction legislated by Congress. If the sequester occurs, it is $22.4 billion.

Mr. **Blum**. Correct.

Senator **Domenici**. All right. On the other hand, the Congress cannot get its job done in that manner until sequester time arrives, because there is another set of rules at that time. Right now we have to get the deficit down to $100 billion from the baseline—get it down to $100 billion assuming whatever economics you can plug into this.

Mr. **Blum**. That is correct. You really will not know what the size of the problem is until mid-July, when the Office of Management and Budget submits its mid-session review on the budget. At that time, the economic assumptions that underlie those estimates will be locked in, as well as other critical assumptions, and that will give you the ball park, then, that you will be playing in.

Senator **Domenici**. Thank you very much.

Chairman **Sasser**. Thank you, Senator Domenici.

Senator Gramm.

Senator **Gramm**. Thank you, Mr. Chairman.

Mr. Blum, let me begin by being sure I am looking at the right figures. The way I look at these figures, the projected revenue under current services—which is, if we do not change anything, do not raise taxes, do not change tax rates, based on what is the current law of the land—you are projecting that revenues without any tax increase will rise by $86 billion next year; is that right?

Mr. **Blum**. That is correct, Senator.

Senator **Gramm**. If you viewed that as sort of a pot of money with which you could do two things—one, reduce the deficit, and the other, to spend—how much of that $86 billion would you have to take to meet the Gramm-Rudman-Hollings targets for next year?

Mr. **Blum**. Oh, you have probably done the arithmetic; I bet you know the answer. [Laughter.]

Senator **Gramm**. Well, I round to the nearest $50 million. That is the excuse I always give my wife. [Laughter.]

Mr. **Blum**. I would be willing to accept that.

Senator **Gramm**. Well——

Mr. **Blum**. Well, let's go through the arithmetic. Revenues go up by $86 billion; our outlays go up by——

Senator **Gramm**. Well, my question is take the $86 billion, look at it as a pot, and how much does the deficit have to be reduced from this year's level to meet the targets.

Mr. **Blum**. Well, the deficit actually has to go down by $55 billion, because we are carrying a $155 billion deficit estimate for 1989.

Senator **Gramm**. So if you did spending as a residual, where you said revenues are going up by $86 billion, and you have got to reduce the deficit by $55 billion, you could sort of work backward—if you worked out a maximum allowable expenditure, you could work that out, and it would be about $31 billion.

Mr. **Blum**. That's what I get.

Senator **Gramm**. So if we could find a way to limit spending next year to no more than $31 billion more than we spent this year, which is a tall order, but if we could do that, then we could meet these deficit reduction targets without changing the tax structure.

Mr. BLUM. That is correct, Senator. I would point out that our baseline outlays actually increase by $71 billion, so you are talking in terms of a cut if you want to allow an increase of only $31 billion.

Senator GRAMM. A cut relative to what we would have spent, not relative to what we did spend.

Mr. BLUM. That is correct. I mean, if you want outlays to grow by only $31 billion, that would mean reducing the projected growth under current law, or on the baselines, by $40 billion.

Senator GRAMM. Now, I have tried to go back and look at revenues as a percent of GNP, and visualize, this $86 billion coming in the front door. With $55 billion going to Gramm-Rudman and $31 billion left to spend, which is, if you round it off, roughly a 3 percent growth in Federal spending, what you have got to ask yourself is: Should we look at raising taxes? And I guess you could say it is an open question, but let me give you some numbers, and as an economist, get your thinking.

As I look, you are already projecting that revenues as a percent of GNP are going to be 19.6 percent in your numbers. Now, I took that 19.6 percent, and started looking backwards, I only find 3 years in the postwar history of America where the number has been that large or larger. Those 3 years are 1969, which I think is when we had the Johnson surcharge for the Vietnam war——

Chairman SASSER. The last time we had a surplus, too.

Senator GRAMM [continuing]. And then, 1981 and 1982, before the full tax cut went into effect, and where we also had a recession so that GNP was going down. I do not find any other year other than those three where the percentage of GNP going to the Federal Government in taxes is higher than it already is today. In fact, I think you could say without fear of contradiction that never in the postwar period, except in 2 years during a recession prior to a tax cut going into effect, and the period of the Johnson surcharge on the Vietnam war, have revenues as a percent of GNP been as high as they are today.

Does it give you any pause as an economist, if you were looking at the strength of the economy, with the fact that there are only 3 years in the postwar history of the country where revenues as a percent of GNP have been as high as they are today, and there is something extraordinary of those 3 years or, out-of-the-ordinary, I should say. Do you think that ought to be a factor that would weigh on us in this deliberation of whether to raise taxes?

Mr. BLUM. Well, Senator, as an economist, I do not know that I have anything to say on that, because I think that represents essentially a political choice, a value judgment as to what should be the relative burden of the Federal Government on the taxpayers.

Clearly, in other countries, that percentage in much higher. But as you say, over that long period of time there have been only 3 years when revenues as a percentage of GNP have been higher than the 19.6 percent that we are projecting for 1990, and I think that has weighed heavily on the deliberations of the Congress and has often led to tax cuts in the past.

Senator GRAMM. So in fact, looking at the 45 fiscal years we have had since World War II, when taxes as a percentage of GNP have been at this high level, that has normally been where we have looked at tax cuts, like when the Kennedy tax cuts at least were debated in 1961, and we were at 18.2 percent of GNP, and that ultimately fell down to 17.4 percent; and then, in 1981, it was at 21.1 percent; and then ultimately, that fell down to 16.4 percent. So at least in the perspective of the 45 years, you would not disagree that again, isolating from the budget debate—because I am not proposing that we cut taxes—but isolating the budget debate out at this level of fiscal burden in the postwar period, normally, the debate in Congress has been not raising taxes but lowering them to reduce the burden.

Mr. BLUM. Well, I think that is correct.

I would point out that over this long period of time there has been a change in the underlying composition of tax revenues, that a much larger share now is raised by payroll taxes, for example, than by income taxes. From the point of view of tax policy, the burden of Federal taxes on taxpayers at different income levels and situations presents issues that the Congress clearly would want to consider, but from the point of view of the overall tax burden, I would stick by my previous observation.

Senator GRAMM. Well, my guess is in fact, given the point that you raised, that with the increased dependence on the payroll tax—this will be my final point—that the median income worker is probably heavier-taxed than that worker has been in the whole postwar period today. Would you agree with that, given the figures that we are looking at and given the change in the composition of the tax, and that in fact the guy who would bear the burden of the gasoline tax and the whiskey tax and the cigarette tax, that that person is more taxed today, bears a heavier burden today, than probably any year since 1945? I know I am asking you to conjecture, but I would bet money that that is true.

Ms. MARCUSS. Well, without getting into the question of the burden of additional taxes, it is definitely true that income and payroll taxes now make up a larger share of total Federal taxes than they did over the 1950s and 1960s and even the early 1970s.

Senator GRAMM. Well, Mr. Chairman, let me conclude by simply saying I think the debate for the 10 years that I have been in Congress and worked on these problems, a lot of debate focuses around what we assume. That is an important debate, but the most important debate is what do we do about it. And I think no matter what assumptions are right—and as I look at the numbers, CBO has overestimated inflation every year since 1984, and my guess is that OMB's forecasts are not much better, if as good—but the point is that no matter what the reality is of the numbers, the more we do about it, the better off we are going to be if you are concerned about reducing the deficit, and I agree with that.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you.

To run through the same exercise, coming at it from a little different angle, Mr. Blum, let us take the $86 billion pot and subtract the $55 billion that we have got to take out to get down to the

Gramm-Rudman-Hollings targets. That leaves you $31 billion, right?

Mr. **Blum**. Yes.

Chairman **Sasser**. Then you back out of that $17 billion that you need for social security cost-of-living adjustments, and additional social security benefits, because that is off the table, so to speak. That leaves you with $14 billion left out of the $86 billion pot to try to deal with the deficit and the other needs of the budget.

Is that a fair assessment?

Mr. **Blum**. I am not sure that strictly the year-over-year increase in social security is quite that much, but basically the point you are making, Mr. Chairman, is correct.

Chairman **Sasser**. The point I am making is that we do not have $31 billion to play with; we have got mandated cost-of-living adjustment in a number of programs and particularly social security.

Mr. **Blum**. Well, we do have an increase of social security in our base. The outlays do increase by $16 billion from 1989 to 1990.

Chairman **Sasser**. I find myself in further agreement with my now-departed colleague Senator Gramm on the matter of taxes that are regressive, payroll taxes. What we have seen over the past 8 years is an increase in percentage of Federal revenue coming from payroll or social security taxes as opposed to other taxes. For example, if memory serves me correctly, payroll taxes or social security taxes have moved up from 1980 from 30 percent of Federal revenues up to 36 or 37 percent of total Federal revenues; in 1988 whereas income taxes have moved down from 47 percent in 1980 to 44 percent in 1988—correct me if I am wrong. Gift and estate taxes have been cut in half since 1980. And excise taxes may have declined somewhat. Corporate taxes have gone down since 1980 by about 2 percent as a percent of total revenue.

The point I am trying to make is that Senator Gramm and I are in agreement in that an undue burden of taxation has been shifted onto the backs of the payroll tax or the social security tax as compared with other Federal taxes over the past 8 years.

Mr. **Blum**. That is a fair point.

Chairman **Sasser**. All right. One final question.

In looking through outlays for fiscal year 1988, I noted that the outlays for FSLIC exceeded your fiscal year 1988 estimates by about $4.8 billion. What is the story on that?

Mr. **Blum**. Actually, we have a chart of our own, Mr. Chairman, on this point, that tracks our various baseline estimates for the Federal Savings and Loan Insurance Corporation over the course of the last year, and the trend is consistently upward.

What happened is that the amount of spending in 1988, for example, turned out to be much higher than we anticipated as recently as last August.

Actually, when we prepared those August baseline estimates for 1988, net outlays through July by FSLIC had only been $1.2 billion. But then they went on a sprint, and from the August 18 to the September 30, the agency issued about $6.5 billion in notes that all got tabulated as outlays on the budget; these were not necessarily cash going out, but they did count under our accounting guidelines as net outlays.

What happened was we had thought the Home Loan Bank Board was constrained, more or less, in its actions to available cash, but they uncovered a honeypot that we did not know was there, which was essentially unlimited borrowing authority based on promissory notes.

As a result, we now take the Home Loan Bank Board at its word that it will, under current law, proceed rather vigorously in resolving the 450 problem cases that it had identified last year, and therefore, our baseline numbers have been raised accordingly.

I might point out, Mr. Chairman, that the FSLIC is an independent agency, essentially operating without any effective constraint from either the Congress or the executive branch. So our baseline estimates represent our best guess at this time as to the impact FSLIC have on the budget if it continues as it has in the last 6 months.

Chairman SASSER. Was there a relation between that and the sequester calculation, Mr. Blum?

Mr. BLUM. Well, yes, in the sense that this all goes into the sequester base as outlays; the more outlays that are in the base, the sequester base, the higher the deficit, and therefore the higher the sequestration percentages for defense and nondefense programs subject to sequestration.

Sequester does not have that much effect on FSLIC.

Chairman SASSER. Do you have readily available there the percent of GNP that was accounted for by Federal revenues in 1980 as opposed to 1987, just to pull a figure out of the air?

Mr. BLUM. Yes. In 1980, revenues as a percentage of GNP were 19.4 percent.

Chairman SASSER. And revenues as percent of GNP in 1987 were what?

Mr. BLUM. 19.3 percent.

Chairman SASSER. So roughly the same.

Mr. BLUM. Yes, sir.

Chairman SASSER. Now, within that 7-year period, what percent of Federal revenues were accounted for by social security receipts?

Mr. BLUM. Well, in 1980, as percentage of GNP it was 4.2 percent; by 1987, that had risen to 4.8 percent.

Chairman SASSER. All right. So almost a full percent, then, of the Federal revenues—a rise of almost a full percent——

Mr. BLUM. During that time period, yes.

Chairman SASSER [continuing]. Accounted for by increase in social security.

Mr. BLUM. And it would continue to rise. In 1988, for example, we are projecting that at 5.1 percent.

Chairman SASSER. And in 1988, what are you projecting Federal revenues as percent of GNP?

Mr. BLUM. For 1988, 19.0 percent.

Chairman SASSER. So could you draw an analogy from this, Mr. Blum, that what we are witnessing is a transfer of the burden of Federal revenues from income taxes, excise taxes, gift and estate taxes, onto a social security tax or a regressive payroll tax?

Mr. BLUM. Well, that is exactly right, and that is what accounts for these growing surpluses in the Social Security Trust Fund.

Chairman SASSER. All right.

Mr. Blum, I want to thank you for your marvelous performance at the Congressional Budget Office over the past year. You have been absolutely marvelous. We are all in your debt for the great good work that you have done. I want to thank you personally for it and thank you on behalf of the committee, and thank you and your colleagues for your presentation here today.

The committee is adjourned.

[Whereupon, at 12:28 p.m., the committee was adjourned.]

VIEWS OF THE BUSH ADMINISTRATION

TUESDAY, FEBRUARY 21, 1989

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee convened, pursuant to notice, at 10:10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Johnston, Riegle, Lautenberg, Simon, Sanford, Wirth, Conrad, Dodd, Robb, Domenici, Boschwitz, Symms, Grassley, Kasten, Nickles, Rudman, Gramm, and Bond.

Staff present: John L. Hilley, staff director; and Alan Cohen, assistant director for budget priorities and review.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman **SASSER**. The committee will come to order.

This morning we are a little late getting underway because Senator Domenici, the ranking member, and myself and Mr. Darman were at the White House in a meeting with the President, discussing matters dealing with the budget.

This morning, we have got a lot of work before us, and Mr. Darman has another pressing engagement this afternoon to meet with the President one last time before the President leaves for Japan. So without objection this morning we will defer opening statements other than mine and the ranking member's——[Laughter.]

Senator **DOMENICI**. That is a good rule.

Chairman **SASSER** [continuing]. And allow the members to use some of their time for opening statements when it comes their time, if they wish to do so.

Is there any objection to that?

Senator **DOMENICI**. No; I think you ought to try that. And were you also going to talk about the order of calling on Senators, Mr. Chairman?

Chairman **SASSER**. Yes; Senator Domenici.

This morning we are going to start calling on Senators in order of seniority as they arrive. We are doing that because we have got a very, very large committee here. We have a number of very senior members who chair other, major committees, and a number of ranking members on other committees, and we feel this will give them an opportunity to participate if we try to follow a modified "early bird" rule here.

Is that satisfactory?

Senator DOMENICI. I think that is fine, Mr. Chairman.

Senator GRASSLEY. Mr. Chairman, would you clarify that? You said by seniority as they arrive. Is it by seniority, or by how we arrive?

Chairman SASSER. It is going to be by seniority, Senator Grassley.

Senator GRASSLEY. OK. I do not find any fault with that. I think that is a pretty good procedure, just as long as you follow it the same way all the time.

Chairman SASSER. Well, when I first got here, I thought seniority was not a very good idea, but the longer I stay here the better that idea looks. [Laughter.]

Today the Senate Budget Committee begins its hearings on the 1990 budget proposals of the Bush Administration. We are pleased this morning to have as our first witness Mr. Richard Darman, the Director of the Office of Management and Budget.

This morning at the White House, President Bush reiterated his call for early action on reducing the budget deficit. I want to say that as Chairman of the Senate Budget Committee, I totally support his efforts to reduce the deficit, and I share his concern about the deficit, as I am sure every member of this committee does.

But I think we need to be clear about what is involved here. To have constructive discussions about the budget deficit, we first must have our facts straight—facts straight about the dimensions of the deficit problem—and we must have facts about the concrete detail of the administration's budget proposals.

Now, there seems to be a difference between the promise of the 1990 Bush budget and the performance or the reality of that budget. First, the administration continues to underestimate, I believe, the seriousness of the deficit problem. The administration estimates the 1990 budget deficit to be $99 billion. But when we use the more realistic and conservative estimates of the nonpartisan Congressional Budget Office, we find that the deficit will be some $20 billion greater than the estimate of the Bush administration.

By 1993, the administration is projecting a balanced budget. The Congressional Budget Office, on the other hand, shows that the deficit in 1993 will stand at $75 billion. Moreover, if we remove the mask of the social security surpluses—and it is a fairly well-known fact now that social security is accumulating substantial surpluses—if we remove that mask, we find that the actual deficit is $200 billion for fiscal 1990 and on into the outyears.

So it appears that at every step of the way we are presented with a rosy but unrealistic economic forecast of declining deficits and diminished fiscal problems, giving, I fear, the American people a false sense of security about the magnitude of the deficit problem that is confronting this country.

The second issue is this one that has received quite a bit of attention in the media, and it is still with us. We still have to deal with the so-called "black box" or "black hole" problem in the Bush budget. One hundred and thirty-six billion dollars, mostly in domestic discretionary and mandatory spending programs, are frozen in this budget; but about $10 billion in savings must be made from these programs to reach the Gramm-Rudman-Hollings deficit targets for fiscal year 1990.

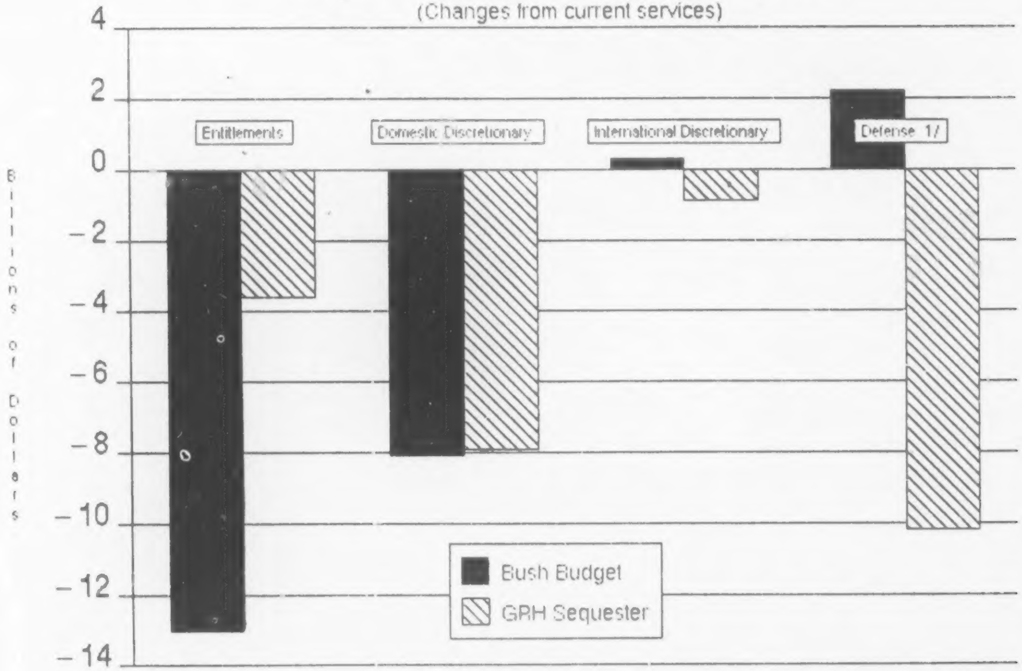
Now, the question we must ask the administration is where are these cuts going to come from. We do not know at this point. The administration has yet to tell us. Will the Superfund be cut, or will compensatory education programs be slashed, or will child nutrition programs be reduced? We just do not know at this juncture from looking at the budget of the administration.

But we do know—as the chart that we are putting up here will reveal—that the overall level of proposed cuts in domestic programs in the Bush budget will be more severe than a sequester under the Gramm-Rudman-Hollings Act.

Bush's Budget Priorities

Defense up, Domestic below sequester

(Changes from current services)



1/ Defense numbers adjusted for military retirement accrual

Senate Budget Committee Staff
February 21, 1989

If we fail to reach a budget agreement this year, a Gramm-Rudman-Hollings sequester would cut domestic discretionary programs by $8 billion. But if we adopt the "black box" approach in the current Bush budget, these programs are going to be cut even more.

And finally, the Bush budget has a flexible notion about what constitutes a freeze. Defense spending is said to be frozen, but actually, as we calculate it, defense spending grows with the rate of inflation and then some. Indeed, there is actually more than a $2 billion increase in defense outlays, and that translates into 1-percent real growth rate. Now, that is the freeze as far as the Pentagon is concerned.

At the same time, there are $130 billion in domestic programs that are literally frozen at the 1989 actual spending levels and may have to be cut even more to reach the Gramm-Rudman-Hollings budget targets.

The freeze on defense spending is already having, it appears, a "spring thaw", while there is still a "hard freeze" on many of the vital domestic spending programs.

So I think the task before us all is clear. Let us be realistic about the dimensions of our deficit problem. Let us be truthful with the American people about how big the budget deficit really is and how long it is going to take us to reduce the deficit. Let us have the facts about what the Bush budget really is. Let us have the details about where the cuts are, where the pain is, and where the gain is in this budget.

Once we establish these facts, then we can really get down to the business at hand, and that is working to reduce the Federal budget deficit in a fair and constructive manner.

I want to turn now to the ranking member for any statement he might wish to make.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman.

I have three pages of prepared remarks; I would ask you to make them a part of the record, and I would just like a couple of minutes to discuss my views.

Chairman SASSER. They will be made a part of the record.[1]

Senator DOMENICI. First of all, I think the President is asking us to expedite this process for a number of reasons. First of all, those who are looking at the American economy are wondering whether or not we are going to be able to strike a deal with the new President and get the deficit within the Gramm-Rudman target of $100 billion for 1990—a rather dramatic decrease over this year's level, and significant improvement by way of deficit reduction.

I believe this morning's meeting in the White House with the President was a very good one. Everyone expressed the desire to negotiate and to get on with expediting our process so that we could assure the marketplace and assure the American people that we do not have to disagree for a whole year; we can disagree for 3, 4, or 5 weeks and then arrive at some compromises.

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[1] See p. 76.

The second point is that the President has highlighted in his budget that revenues will increase under current law without any new taxes by $82 billion, and then he has proceeded to distribute that increase in this budget.

There is still some concern—and I am not critical of that concern—about the residual $136 or $120 billion, depending upon what you want to include in it. I think we have to understand how that was arrived at and what it might mean in the sense of the appropriations process. But let me make sure everyone here knows that even if we know what the administration's recommendation was on each of the thousand or so programs in that group, all we would do would be to package it up into functions of government, and the appropriators will decide what goes up and what comes down, and hopefully, what is eliminated. So I do not think we have to know the details, but rather we need an overall view of how tough it is and whether it is fair, and whether it will reach the targets.

Now, my assessment of this budget is slightly different from my friend from Tennessee, and let me tell you my view in five points.

The overall Bush budget would have spending increase by $14.1 billion 1990 over 1989—a 1.2-percent increase resulting in the $1.157 trillion total outlay level.

Defense outlays would increase by seven-tenths of a percent between 1989 and 1990. Budget authority for defense would go up 3.4 percent.

International affairs would go up by $1 billion, and the domestic discretionary programs would grow by $5.3 billion—that includes all domestic discretionary programs. Some are expected to go up, but they are within the control of the appropriators. The total increase for domestic discretionary is 3 percent. This category of the budget represents less than 16 percent of total spending, and it grows at 3 percent while defense, as I indicated, in outlays, grows by seven-tenths of a percent.

The area where the President has restrained most might be the most difficult for us to accomplish. Entitlements and mandatory expenditure programs will increase by only $2.7 billion. That is a one-half of 1 percent increase. That is where you find the medicare savings, the Farm Program savings and others. I do not agree with all of those; everyone on this committee will not—but that is a fact of the Bush budget.

Interest will go up $4.5 billion, for a 2.7 percent increase. So you look at this budget, and essentially, we are going to have to decide whether we can do those increases and/or reductions over expected growth without new taxes. If we want to do them without new taxes—and that seems to be the goal here other than this $82 billion in new revenues that come automatically—then I believe within 2 weeks or so, we ought to know whether we can realistically expect conduct on the part of Congress consistent with these targets. Then my hope is that we will move from there to where we would take the matter to some kind of a summit and agree as we did 18 months ago, with broad mandatory targets, three or four, no more. I believe then, if we implement a budget in a timely manner, we will get the results that we want.

Thank you very much, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Domenici.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT

SENATOR PETE V. DOMENICI

Hearing on President Bush's FY 1990 Budget

February 21, 1989

I am pleased to join with the Chairman in welcoming you, Mr. Darman, in your first appearance before the Senate Budget Committee. You have made an extraordinary effort, in a very short period of time, to produce the Bush budget plan. You are to be complimented.

I know that there has been an undercurrent of criticism that the Bush Budget is somehow not a real budget. There seems to be the suggestion that it identifies only the new areas for spending, without telling us where the cuts will be.

I would like to make a few observations on this point, before our witness begins his testimony.

First, the President's budget uses current year outlay spending as the starting point. As the President has said, "we must recognize that growth above inflation in federal programs is not pre-ordained, that not all spending intiatives were designed to be immortal."

This is a common sense approach that the American people can understand.

In the past the Budget Committee has used a similar concept for looking at all of the discretionary programs of government. This approach, called "current law spending," does not adjust for inflation as the budget "baselines" we usually use around here. A current law baseline adjusts for caseload and mandatory spending.

The point I am making is that the notion of starting with 1989 spending may appear cumbersome at first. But it is not wildly new. It's the way families and corporations budget.

Second, the vast majority of the restraint is specified quite clearly. This budget limits the growth in outlays in fiscal 1990 to $14.1 billion. The budget specifies all of the changes in entitlements, user fees, and asset sales, and it lays out a number of new discretionary initiatives.

What is "unknown," so to speak, is a pool of programs covered by the term "nondefense discretionary programs," over which the President has said over and over that he is willing to negotiate.

This again is not exactly innovative budgeting. This Committee, in almost every budget but a very, very few that I can remember, has done exactly the same thing. We make general assumptions, usually about appropriated programs, then leave it to the authorizing and appropriation committees to decide spending. Indeed, we have been notoriously vague about just how entitlement cuts, domestic spending, and tax increases should be achieved.

My third and final point is that the major instrument for deficit reduction in the President's budget is not spending cuts at all -- but rather revenue increases that will occur as a result of the strong economy.

The federal government will take in $81.5 billion more in revenues next year as a result of the tax laws already in existence. The American public simply asks that we attempt to allocate that additional revenue wisely before we talk about adding new taxes.

From my perspective, we have all of the ingredients to begin to work out a budget agreement. There is a willingness to compromise on the part of the White House that, for this Senator, is truly extraordinary.

Clearly there are things in this Budget proposal that I have had problems with in the past, and will continue to have problems with. Mr. Darman, you are aware of those concerns, as they relate to Civil Service and Military Retirees COLA's and restrictions on the U.S. Postal Service.

But we can work together. Indeed I hope this entire Committee and Congress can work with you to produce an early, credible, and substantial budget agreement.

Chairman **Sasser**. We will now turn to Mr. Darman.

I want to welcome you before the committee, Mr. Darman. We look forward to your statement and observations this morning.

STATEMENT OF RICHARD DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. **Darman**. Thank you very much, Mr. Chairman.

It is a pleasure to be here before you.

May I ask one matter of procedure? I understood you to say that all but the chairman should dispense with opening statements. Did you mean that I should do so? I am happy to do so if that is what you would wish.

Chairman **Sasser**. No; you may do as you wish. You may use your prepared opening statement, or you may summarize that—any way you wish to approach it—just to get your full views out here this morning.

Mr. **Darman**. Would you mind if I would read it?

Chairman **Sasser**. No; we would be delighted to have you read it.

Mr. **Darman**. I would be happy to do so, but alternatively, I would be happy to abbreviate it. It is not too long.

Chairman **Sasser**. No; go ahead and read it. That is fine.

Mr. **Darman**. All right. Thank you.

Chairman Sasser, Senator Domenici, distinguished members of the Senate Budget Committee, thank you very much for this opportunity to discuss the President's budget proposals.

I appear before you in what I hope you will find to be a constructive spirit, seeking to advance our common objective—not merely the adoption of a budget resolution, but the prompt enactment of a responsible budget program that can meet the Gramm-Rudman-Hollings deficit reduction targets on schedule.

In seeking to meet this objective, the President has suggested that a responsible set of budget proposals must pass several basic tests.

They must attend to fundamental obligations—such as the payment of interest, the protection of national security and the funding of social security.

Within the limits of scarce resources, they must address special obligations to the poor, as through means-tested entitlement programs and incentives for child care; and to future generations, as through environmental protection.

They must begin to remedy problems inherited from the past—the scourge of drugs; the crisis in the savings and loan sector; the failure adequately to invest in the modernization and cleanup of nuclear weapons production.

And they must advance priorities for future American growth and competitiveness, as through measures to encourage sound investment in research, education, enterprise and long-term productivity.

They must do all these things while also restoring fiscal balance—meeting the Gramm-Rudman-Hollings targets without raising taxes and without threatening the continuation of what is now America's longest period of sustained peacetime economic growth.

The President's proposals were presented to the Congress on February 9 in a 193-page volume titled, Building a Better America. His proposals meet the several tests I have noted, and I would respectfully request that they be included in the record for your further consideration.

The presentation of the proposals stirred a bit of attention for its effort to change a local habit of mind. That habit has a curious "Wonderland" quality. It is described by a phrase that is unknown to most of the country but common among Washington budgeteers: "current services baseline budgeting".

Let me try to put this in perspective. The "current services" approach tends to suggest that all programs funded in the past must be funded at at least equivalent service levels in the future, with a built-in upward adjustment for inflation and other factors. In a sense it treats spending programs as immortal, and it treats inflation as an acceptable given.

If a program is preserved and increased, but not quite as fast as inflation—if it grows, say, from 100 to 102—then in the terminology of the current services "Wonderland", it is said to be "cut". And political leaders in the Executive Branch and the Congress often take credit for "cutting" the deficit as they thus increase spending. What they cut, of course, is the "current services" baseline deficit, while the actual deficit may continue to rise.

In ordinary life, 103 is not a "cut" relative to 100. But in the world of "current services", things are different. It is a "Wonderland" phenomenon: a "cut" is really an increase; a deficit said to be going "down" is really going up.

I do not mean to suggest that the concept of "current services" is utterly inappropriate for some kinds of analysis. Indeed, although we have not budgeted on the basis of current services, we have recognized the committee's analytic interest. Accordingly, we have provided the committee with all of the necessary economic and technical assumptions to establish a current services baseline or to modify the prior current services baseline.

But having done so, let me emphasize, we should not get lost in the technicalities of alternative baselines. The larger issue involves a habit of mind. If the real world deficit is to be reduced, programs must not be assumed to be immortal; inflation must not be built in as given; and last year's level of service in every program must not be treated as the presumed minimum acceptable level for next year.

The frame of reference must be made more common-sensical. Next year's budget must be framed in relation to last year's actual spending and in relation to available resources and deficit targets—not in relation to some hypothetical, perpetually expanding "current services" baseline.

There have been too many compromises announcing heroic "savings" measured against ethereal constructs. It should be little wonder that fictional "savings" have failed to materialize. The fiction should not continue. The deficit is rising. It is time to do something real.

Now, whatever one's views on the "Wonderland" budgeteers' habit of mind, there is another issue of perspective that is, I think, even more important. Whether we budget from last year's levels or a zero base or current services, or anything else, it is essential that we give greater attention to investment in the future. As a matter of analysis, that means we must attend to the relative emphasis given to new spending for current transfers in consumption versus the emphasis given to new spending for future gains in productive power and the quality of life.

Our freedom for spending initiations is limited. We are constrained by problems from the past and obligations to the present. But within the limits set by these constraints, President Bush's proposed initiatives tilt toward the future. They emphasize: investment in research and development, with major funding increases for basic science, biomedical research, space, and the Superconducting Super-Collider, as well as proposed improvements in the research and experimentation expense allocation rules and the research and experimentation tax credit.

They emphasize investment in education and child development, with proposals for a new Merit Schools Program, a new National Science Scholars Program, increased funding for historically black colleges, magnet schools, Head Start, and experimentation and innovation, as well as a new refundable tax credit of up to $1,000 for each child under four with a working parent in low-income families; and a related proposal to make the existing child care credit refundable, along with the restoration and doubling of the adoption expense tax deduction.

They emphasize investment in the protection of the environment, with proposals for clean coal technology development, a new Clean Air Act, postponement of OCS drilling off of California and Florida, as well as tougher reduction requirements and enforcement for hazardous waste cleanup, ocean dumping and protection of wetlands.

They emphasize investment in combatting drug abuse, with proposals that would require an outlay increase of almost $1 billion for fiscal year 1990.

And they emphasize investment in the creation of incentives for new economic opportunity, with proposals for a new longer-term capital gains initiative and provision for up to 70 enterprise zones.

The list of seemingly worthy claims always exceeds available resources. It is limited only by human imagination. The necessity for choice is inescapable.

For a summary of the President's priority choices, I would refer you to Appendices B and C of the testimony that I am providing now and ask that they be included in the record.

But in making choices, it is important to note: The voters of the present are well-represented; the citizens of the future are less so. At the margin of choice, they must depend on the wisdom and generosity of a present generation that is willing to invest in the future.

But now the question is rightly asked—how do we finance all this? The answer, I would contend, is straightforward. The first and most important contributor is economic growth. With a growing economy, and no change in current law, revenues are projected to increase from $978.6 billion in fiscal year 1989 to $1.06 trillion. That is an increase of more than $80 billion. The Congressional

Budget Office, by the way, estimates even higher revenues than the administration.

That increase is no small amount of money. It is more than the gross national product of 137 countries of the world.

Even so, with the claims made by deficit reduction, fundamental and special obligations, problems from the past, and priorities for initiative and investment, there is also need for restraint on the growth of the remainder of the budget. This need is mitigated somewhat by certain mandatory programs that naturally decline. It is mitigated further by our ability to make sensible reforms in programs that would otherwise be an excessive drain on limited resources. Our suggestions there, by the way, are at Appendix E.[1]

Still, in order to meet the Gramm-Rudman-Hollings targets, there remains a need to freeze the remainder of the budget as follows: freeze all retirement COLAs for Federal civilian and military employees for 1 year; freeze defense budget authority at zero real growth for 1 year; and freeze residual non-defense spending at 1989 levels for 1 year.

With these steps, it is possible to fund necessary and desirable program growth while also reducing the budget deficit below the targets of $100 billion in fiscal year 1990 and zero in fiscal year 1993.

That said, I must emphasize that these rather exact projections are not what I would forecast. They are dependent on a host of variables and conditions that are not wholly within our control or our ability to forecast reliably.

One of the key conditions is political, not economic: Our projections depend upon prompt Congressional enactment of the President's program or something close to it. Clearly, if there is not prompt and responsible legislative action to reduce the deficit, there will be greater market risks, and it will be substantially less likely that our conditional projections may be achieved in the manner intended. We would have to rely upon sequester, which is a clumsy way to proceed, although a necessary backup discipline.

As for economic assumptions, these, of course, are endlessly arguable. Here, I would make three general points. First, although micro-economics has much to recommend it, macro-economics is not really well enough developed to justify its claim to the label "science". It is highly fallible. In the period 1981 to 1988, for example, the Administration, CBO and the "Blue Chip" group of forecasters all had large mean errors in their forecasts of nominal GNP for 1 year ahead. The mean errors were 2.6 percent, 2.4 percent and 2.6 percent, respectively.

It is a regrettable fact of macro-economic forecasting that forecasts are often closer to each other than they are to being correct.

Second, the administration's assumptions are perhaps most vulnerable with regard to outyear interest rates. It is at least noteworthy, however, that it is possible for others to be wrong in addition to the administration. In 1982, for example, CBO forecast 1983 T-Bill rates at 13.2 percent; Blue Chip forecast T-Bill rates at 10.7 percent. Reality came in much lower, at 8.6 percent. In 1985, one saw the same pattern. Blue Chip forecast 9 percent for 1986; CBO forecast 8.7 percent; reality came in at 6 percent.

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[1] See p. 93.

I am not trying to suggest that the administration is right and others are wrong. Rather, I mean to suggest simply that we should not have too much faith in any macro-economic forecasts. In the end, it is probably not a bad idea to rely upon common sense.

The Chairman of the Federal Reserve has said that if a program of deficit reduction such as the President's were enacted, he would expect interest rates to come down substantially. To me, it seems common-sensical that if we wish to see interest rates come down in the current context, we should move forward with responsible deficit reduction.

Third, the administration's long-term sustainable real growth projection, averaging about 3.25 percent, has been challenged by some who believe it should or must be lower. From 1948 to the present, however, a period that includes eight recessions, real growth in the American economy has averaged 3.25 percent. I see no reason to settle for a lower long-term projection than we have been able to achieve over the past 40 years. To do so would be unnecessarily defeatist.

The argument ought not to be about whether or not we should lower the future trend line. Rather, it should be about what set of policies are most likely to assure that we are capable of sustaining our historic pattern of growth.

For our part, we believe that policies such as the President's—policies that would lower the deficit, increase savings and investment, increase R&D, increase investment in human capital, and ultimately increase productivity—that these are the key to sustaining growth.

That said, I should emphasize that we do not pretend to have either all the answers or the only acceptable set of answers. We have offered a set of proposals that we believe have merit. We look forward to learning of other proposals and to discussing them on the merits.

We mean to be cooperative. As of February 18, in response to requests for further detail, we had provided well over 500 additional pages of data and tables beyond the initial 250 pages of proposals and explanations. I am providing some additional data here today on rescissions and supplementals, on financial flows associated with our savings and loan sector reform proposals and on the President's budget, presented in the Bipartisan Budget Agreement framework.

We have provided your staff with a more detailed presentation that goes down to the level of each individual account; we did that over the weekend.

With these various submissions, and through informal consultations as well, I think it not only fair to say that we have presented a complete and detailed budget, but we have also submitted more data and explanation than any new President has done at a comparable stage in the modern budgeting era.

Here, I would refer you to Appendix A,[1] which has a brief summary of the submissions we have made and submissions made by prior Presidents at a comparable stage of their tenure.

But this, of course, is not enough. We cannot unilaterally produce a budget. We in the executive branch cannot legislate. We can offer and exchange views. But in the end, we must come to an Executive/Legislative agreement. To that end, as a practical matter of reality, we must negotiate.

From our perspective, that process would best begin sooner rather than later.

Although the real economy remains strong, interest rates are rising, and markets seem less firm than one would wish. Our government is divided between the two great parties. That division is viewed by some as a formula for stalemate; and stalemate is fraught with risk. But it need not be so.

The President has said that this is not time to settle for business as usual. Our job, as we see it, is to do our utmost to make divided government work. We are prepared to negotiate in good faith, in a bipartisan spirit, to work day and night if that is what it takes, to reach a constructive agreement.

In that spirit, Mr. Chairman, and distinguished members of the committee, I would be pleased to try to respond to your questions.

May I just thank you again for inviting me to appear before you today, and thank you, Mr. Chairman, for allowing me to read this statement.

I ask, if I may, that the appendices be included in the record.

Chairman **Sasser**. They will be included in the record. Thank you, Mr. Darman.

[The appendices referred to in Mr. Darman's statement follows:]

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[1] See p. 87.

APPENDICES

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Appendix A

INITIAL PRESENTATIONS OF BUDGET DATA BY NEW PRESIDENTIAL ADMINISTRATIONS—1969–1989

During the past 20 years, the Presidency has changed hands five times: January 1969, when President Nixon succeeded President Johnson; August 1974, when President Ford succeeded President Nixon; January 1977, when President Carter succeeded President Ford; January 1981, when President Reagan succeeded President Carter; and January 1989, when President Bush succeeded President Reagan.

Because a President who leaves office following a November general election presents his last budget request to Congress in January, shortly before the inauguration of his successor, the new President is given the opportunity to transmit an amended budget to Congress. He is under no legal obligation to do so. Of the four Presidents listed above who took office in January, each transmitted a revised budget to Congress. However, the extent of the revisions and the amount of detail provided has varied substantially—as suggested by the following summary.

President	*Submission*	*Scope*	*Date*
Nixon:	12-page memorandum.	Estimates for 1969 and 1970; reestimate of receipts postponed; no out-years; no current services.	April 15, 1969
Carter:	101-page compilation of Message and tables.	Estimates for 1977 and 1978; no comparison with or use of current services baseline; disclaimer: "The 1978 budget is essentially still President Ford's budget, with only such limited revisions as my Administration has had time to make."	February 22, 1977
Reagan:	"Program for Economic Recovery."	1981–86; program changes—but with line for "budget savings to be presented subsequently."	February 18, 1981
	"1982 Budget Revisions."	BA/outlays by function, 1980–82 (compared with Carter, not with current services)—but with "additional savings to be proposed."	March 21, 1981
	"1982 Budget Revisions, Additional Details or Budget Savings."	Proposed program changes (not all) with BA/outlays, 1981–86.	April 7, 1981

President	*Submission*	*Scope*	*Date*
Bush:	"Remarks by the President to the Joint Session of Congress," 9 pages, with supplement entitled *Building a Better America*, 193 pages.	1989–93; proposed complete budget, including specific program initiatives (with outlays by function), reforms, natural declines, and special obligations.	February 9, 1989
	"General Explanation of the President's Budget Proposals Affecting Receipts," 55 pages.	In-depth discussion of 11 specific governmental receipt proposals, 1989–93.	February 9, 1989
	Supplementary data package provided to the Budget Committees, 28 pages.	Bridge from Reagan to Bush G-R-H baseline. FY 1990 Non-Defense Discretionary Residual Options, by Function/Subfunction. Economic and technical changes since January, 1989–1993. Adjustments for Credit Reform Component of Reagan Budget, 1989–1993. Asset Sales Component of Reagan vs. Bush Budgets, 1989–1993. Bush Structural Reforms vs. Current Services, 1989–1993. National Defense Budget Levels, 1988–1993.	February 16, 1989
	Supplementary data package provided to the Budget Committees, 491 pages.		February 18, 1989
	192 pages	FY 1990 Bush Budget Priority Programs by FY 90 BBA Category/Function/Subfunction/Account.	
	110 pages	FY 1990 Mandatory Residual Options by Function/Subfunction/Account.	
	4 pages	FY 1990 Defense Residual Options by Function/Subfunction/Account.	
	185 pages	FY 1990 Non-Defense Discretionary Residual Options by Function/Subfunction/Account.	

Appendix B

PRESIDENT BUSH'S BUDGET—AREAS OF PRIORITY INITIATIVE SPENDING

(In millions of dollars)

	1989		1990		Total Increase	
	BA	Outlays	BA	Outlays	BA	Outlays
Investing in R&D and Long-Term Productive Capacity						
Basic research	2,707	2,613	3,068	2,905	361	292
National Aeronautics and Space Administration	10,898	10,596	13,274	12,597	2,376	2,001
Superconducting Super Collider	100	100	250	206	150	106
National Institutes of Health	6,543	6,250	6,777	6,600	234	350
Census	655	672	1,497	1,587	842	915
Investing in People						
Department of Education	17,280	16,336	17,874	17,104	594	768
Ending the Scourge of Drugs						
Drug abuse	5,331	4,569	5,966	5,543	635	974
Prisons and other Justice Department programs	4,025	3,979	4,460	4,297	435	318
Meeting Special Obligations: A Kinder, Gentler America [1]						
Land and water conservation	206	240	206	244	—	4
Acid rain	190	92	710	120	520	28
Homeless:						
Fully fund the McKinney Act	466	408	746	496	280	88
Non-McKinney homeless initiative	—	—	50	25	50	25
Other assistance for homeless	125	92	211	124	86	32
Head Start	1,235	1,202	1,485	1,351	250	149
YES—Youth Engaged in Service	—	—	25	21	25	21
HIV/AIDS	1,287	1,217	1,600	1,377	313	160
Medicaid	34,301	34,301	37,616	37,616	3,315	3,315
Attending to Problems of the Past [2]						
Atomic energy clean up and modernization	2,588	2,536	3,663	3,237	1,075	701
Federal Aviation Administration	6,591	5,733	7,743	6,639	1,152	906
Securing a More Peaceful World						
International affairs	17,598	16,660	19,314	17,677	1,716	1,017
Total (excluding double counts)	111,631	107,239	125,974	119,234	14,343	11,995

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[1] Social security and means-tested entitlement programs are fully funded, but they are not reflected in this table.

[2] The comprehensive reform package (involving public and private resources) for FSLIC is described in Section III B–1 of *Building a Better America*.

Appendix C

PRESIDENT BUSH'S BUDGET—RECEIPTS PROPOSALS AND PRIORITY RECEIPTS INITIATIVES

(In billions of dollars)

	1989	1990	1991	1992	1993
Reagan proposals:					
Receipts [1]	−*	1.2	3.2	3.0	2.6
Offsetting collections [2]	—	5.2	3.1	1.4	3.2
Total, Reagan proposals	−*	6.4	6.3	4.4	5.8
Bush proposals:					
Establish child care credit [3]	—	−0.2	−1.9	−2.2	−2.5
Restore and double adoption deduction	—	−*	−*	−*	−*
Provide credit for intangible drilling	—	−0.2	−0.3	−0.3	−0.4
Revise AMT for exploratory drilling by independents	—	−0.1	−0.1	−0.1	−0.1
Provide credit for tertiary enhanced recovery	—	−*	−*	−*	−*
Establish enterprise zones	—	−0.2	−0.2	−0.3	−0.4
Enhance long-term investment incentives	0.7	4.8	4.9	3.5	2.2
Extend existing telephone excise tax [4]	—	—	1.6	2.6	2.8
Total, Bush proposals	0.7	4.2	4.0	3.2	1.6
Total proposals	0.7	10.6	10.3	7.6	7.4

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* $50 million or less.

[1] Includes HI coverage of State and local employees, R&E allocation rules, R&E tax credit, IRS enforcement initiative, NRC and FEMA fees, and aviation-related taxes.

[2] Includes credit user fees, service user fees, Outer Continental Shelf receipts, Arctic National Wildlife Refuge, Chlorofluorocarbon production rights, unassigned spectrum, and customs service. Does not include an increase in the veterans loan guarantee fee proposed in the January budget, and lease sales off the coast of California (sales #91 and #95) and the coast of southern Florida (sale #116, south of 26 degrees north latitude) proposed in the January budget.

[3] Includes the effect on outlays. Eligibility commences in 1990, but most refunds are not paid until 1991.

[4] Net of income tax offsets. Assumes extending the current tax of 3 percent.

Appendix D

PRESIDENT BUSH'S BUDGET—MANDATORY PROGRAMS THAT NATURALLY DECLINE UNDER CURRENT LAW

(In millions of dollars)

	Current Services		
	1989	1990	Decrease
International affairs:			
Development and humanitarian aid, offsetting receipts	–480	–505	–25
Conduct of foreign affairs	15	9	–6
International financial, excluding Export-Import Bank	–68	–81	–13
Energy:			
Tennessee Valley Authority	540	300	–240
Nuclear waste disposal fund	–526	–538	–12
Nonconventional fuel	159	4	–155
Agriculture:			
Commodity Credit Corporation	13,036	12,645	–391
Crop insurance fund	1,049	356	–693
Commerce and housing credit:			
Ginnie Mae mortgage-backed securities	–210	–313	–103
Federal Housing Administration, excluding asset sales	1,537	586	–951
Federal Deposit Insurance Corporation	3,807	–1,324	–5,131
National Credit Union Administration	–169	–195	–26
Science and technology	189	152	–37
Transportation:			
Panama Canal fund	34	–4	–38
Education, training, employment, and social services:			
Guaranteed student loans	3,602	3,282	–320
Income security:			
Means-tested:			
Aid to Puerto Rico	908	825	–83
Supplemental Security Income	11,389	11,038	–351
Family support	9,847	9,581	–266
Earned Income Tax Credit	3,849	3,841	–8
Other:			
Disabled coal miners	1,529	1,505	–24
Pension Benefit Guaranty Corporation	–301	–415	–114
Federal employee life insurance	–782	–842	–60
Low-rent public housing loans	788	503	–285

PRESIDENT BUSH'S BUDGET—MANDATORY PROGRAMS THAT NATURALLY DECLINE UNDER CURRENT LAW—Continued

(In millions of dollars)

	Current Services		
	1989	1990	Decrease
Veterans benefits and services:			
GI bill and readjustment benefits	620	451	–169
Third-party reimbursement	–138	–304	–166
Loan guaranty fund, excluding fees and asset sales	1,758	1,582	–176
Administration of justice:			
Customs fee	–637	–771	–134
General government:			
OPM revolving fund	–11	–25	–14
Mineral and land payments	547	511	–36
Total	51,881	41,854	–10,027

Appendix E

PRESIDENT BUSH'S BUDGET—STRUCTURAL REFORMS IN MANDATORY PROGRAMS

(Outlays in billions of dollars)

	1989	1990	Dollar Change
Medicare	84.5	92.5	+8.0
Federal Employees Health Benefits	1.9	1.6	–0.3
Farm Support Payments	13.9	10.7	–3.2
Power Marketing Reforms	–0.6	–1.5	–0.9
Lump-Sum Federal Retirement Benefits	1.6	0.6	–1.0
Other [1]	2.9	2.0	–0.9
Total	104.2	105.9	+1.6

	1990	1991	1992	1993
Savings from Current Law:				
Medicare	–5.0	–8.1	–10.7	–13.6
Federal Employees Health Benefits	–1.2	–1.5	–1.8	–2.0
Farm Support Payments	–1.9	–1.8	–2.4	–2.4
Power Marketing Reforms	–0.9	–0.6	–0.5	–0.5
Lump-Sum Federal Retirement Benefits	–2.1	–2.2	–2.4	–2.5
Other [1]	–0.6	–0.2	–0.2	–0.4
Total	–11.8	–14.4	–18.0	–21.3

[1] Other includes a 1990 adjustment for electronic transfers of food stamp cash balances, reform of guaranteed student loans, and extensions of a 1 percent VA loan fee and VA asset sales.

Appendix F

PRESIDENT BUSH'S BUDGET—APPLYING THE RESIDUAL FREEZE

(Outlays in billions of dollars)

	1989	1990	Dollar Change	Percent Change
Freeze residual non-defense spending at 1989 levels ("nominal freeze") [1]	136.0	136.0	—	—
Freeze Federal retirement COLAs	51.2	52.7	1.5	2.9
Freeze defense budget authority at zero real growth [2]	289.8	291.2	1.4	0.5
Total	477.0	479.9	2.9	0.6

[1] This nominal freeze applies to all programs except social security and other social insurance program benefits, means-tested entitlement benefits, programs subject to structural reforms, mandatory programs that decline naturally, initiatives (including S&L reform) specified in the Bush budget, net interest, undistributed offsetting receipts, and asset sales.

[2] The defense freeze is applied to budget authority for subfunction 051. Numbers presented above are the associated outlays.

Appendix G

PRESIDENT BUSH'S BUDGET—FLOWS ASSOCIATED WITH FINANCIAL SECTOR REFORM

(In billions of dollars)

	1989	1990	1991	1992	1993	1989–1999
FSLIC and RTC Account						
Disbursements:						
Old cases and other expenses:						
Administrative and miscellaneous	0.3	0.3	0.3	0.3	0.3	2.8
Notes issued	9.7	—	—	—	—	9.7
Interest on notes outstanding	1.4	1.5	1.1	0.9	0.8	9.2
Repayment of notes issued prior to 1987	—	—	0.2	—	0.2	0.5
Assistance payments	5.2	4.4	3.8	4.2	3.4	28.8
Liquidations	1.0	—	—	—	—	1.0
Total, old cases and other expenses	17.7	6.2	5.5	5.4	4.7	52.2
New cases:						
Assisted mergers	5.0	12.5	8.5	1.2	1.8	44.0
Liquidations	5.0	12.5	8.5	1.2	1.8	30.0
Total, new cases	10.0	25.0	17.0	2.4	3.6	74.0
Total disbursements	27.7	31.2	22.5	7.8	8.3	126.2
Collections (–):						
FICO proceeds (CEBA) (–)	–3.8	–3.3	—	—	—	–7.1
New REFCORP proceeds (–)	–10.0	–25.0	–15.0	—	—	–50.0
Insurance premiums:						
Before deductions (–)	–2.1	–2.3	–2.7	–2.9	–3.1	–31.6
Deduct (+):						
FICO (CEBA) interest	0.6	0.9	1.0	1.0	1.0	10.7
Secondary reserve credit	0.1	0.1	0.1	0.1	0.3	0.7
Defense new bond principal	—	1.7	1.7	—	—	3.3
Net premium income (–)	–1.4	0.4	0.1	–1.8	–1.7	–16.9
Proceeds from receivers and corporate-held assets (old cases) (–)	–1.4	–1.4	–1.2	–1.0	–1.4	–9.7
Income on investment balances (–)	–0.1	—	—	—	–0.1	–1.1
Other collections (–)	–0.4	–0.4	–0.4	–0.3	–0.3	–3.5
Total collections	–17.0	–29.8	–16.5	–3.2	–3.6	–88.3
FSLIC/RTC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Repayments of notes issued after 1986	0.4	0.3	0.1	—	1.1	19.2
Balance of FSLIC notes outstanding (end-of-year)	19.2	18.9	18.6	18.5	17.3	—
FSLIC/RTC cash/investment end-of-year balances (9/30/88 = $1.9 billion):						
Balance for cases	0.6	0.5	0.5	0.5	0.5	0.5
Balance for new fund	—	—	—	1.0	2.1	8.8

PRESIDENT BUSH'S BUDGET—FLOWS ASSOCIATED WITH FINANCIAL SECTOR REFORM—Continued

(In billions of dollars)

	1989	1990	1991	1992	1993	1989–1999
Summary of Accounts Affected						
FSLIC net outlays	10.7	1.4	6.0	4.6	4.7	37.9
Treasury contribution to REFCORP interest	0.5	1.4	1.6	0.9	0.8	22.0
Additional FDIC collections	—	–0.8	–1.6	–1.7	–1.8	–19.9
Total budget outlays	11.1	1.9	6.0	3.8	3.7	39.9

Appendix H

PRESIDENT BUSH'S BUDGET—RESCISSIONS AND SUPPLEMENTALS FOR FISCAL YEAR 1989

(In billions of dollars)

	Budget authority	Outlays	Revenues	Deficit
Rescissions [1]	—	—	—	—
Mandatory supplementals:				
Guaranteed student loans (pending from January)	—	0.3	—	0.3
Guaranteed student loans (change for economics)	0.6	0.4	—	0.4
VA compensation, pensions, and burial benefits	0.7	0.7	—	0.7
VA readjustment benefits	*	*	—	*
VA loan guaranty	0.3	0.3	—	0.3
TAA training and benefits	0.1	0.1	—	0.1
Other Supplementals: [2]				
Forest Service firefighting	0.3	—	—	—
Student financial assistance	*	—	—	—
Foster care/adoption assistance [3]	0.4	0.4	—	0.4
Total supplementals	2.4	2.2	—	2.2
Other changes:				
Administrative actions:				
Advanced deficiency payments	—	0.8	—	0.8
Strategic petroleum reserve	—	0.1	—	0.1
Substantive legislation:				
Guaranteed student loans	—	—*	—	—*
Capital gains tax reduction	—	—	0.7	−0.7
FSLIC	—	0.4	—	0.4
Amtrak unemployment insurance tax	—	—	—*	—*
Treaty ratification:				
Compact of free association	0.2	0.2	—	0.2
Related debt service	*	*	—	*
Grand total	2.6	3.7	0.7	3.0

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[1] President Reagan's rescissions are withdrawn.

[2] Excludes supplementals that are entirely offsetting.

[3] Foster care/adoption assistance figures were not included in published numbers. All other supplementals were included.

Appendix I

PRESIDENT BUSH'S BUDGET—RECEIPTS, OUTLAYS, AND PROJECTED DEFICITS

(Assuming Prompt Implementation of the President's Proposals)

(In billions of dollars)

	1989	1990	1991	1992	1993
Receipts	979.3	1,065.6	1,147.6	1,218.6	1,286.6
Outlays, excluding asset sales	1,149.9	1,160.4	1,211.8	1,249.2	1,284.1
Deficit, excluding asset sales	170.7	94.8	64.2	30.6	–2.5
G-R-H targets	136.0	100.0	64.0	28.0	0.0
Deficit, including asset sales [1]	163.7	91.1	61.9	26.8	–3.8

[1] The 1989 amount is $0.4 billion higher than the February 9 estimate to adjust for all supplementals—including foster care/adoption assistance, which was omitted in the February 9 calculation.

Appendix J

PRESIDENT BUSH'S BUDGET—PRESENTED IN BUDGET SUMMIT FRAMEWORK

(In billions of dollars)

	1989 February Estimate	1990 Bush Budget	1990 Bush vs. 1989 Est.
Priority:			
Department of Defense:			
Budget Authority	290.2	299.3	+9.1
Outlays	289.8	291.2	+1.4
Atomic energy cleanup:			
Budget Authority	2.6	3.7	+1.1
Outlays	2.5	3.2	+0.7
Other:			
Budget Authority	6.0	6.0	—
Outlays	5.9	5.9	—
Total:			
Budget Authority	298.8	309.0	+10.2
Outlays	298.3	300.4	+2.1
International Discretionary:			
Priority:			
Budget Authority	17.6	19.3	+1.7
Outlays	16.7	17.7	+1.0
Freeze:			
Budget Authority:			
Option 1 (RR method)	0.7	0.1	–0.6
Option 2 (nominal outlays [a])	0.7	0.7	—
Outlays	–0.3	–0.3	—
Total:			
Budget Authority:			
Option 1 (RR method)	18.3	19.4	+1.1
Option 2 (nominal outlays [a])	18.3	20.0	+1.7
Outlays	16.3	17.3	+1.0
Domestic Discretionary:			
Priority:			
Budget Authority	47.5	55.5	+8.0
Outlays	56.9	62.1	+5.2
Freeze:			
Budget Authority:			
Option 1 (RR method)	95.9	91.3	–4.6
Option 2 (nominal outlays [a])	95.9	94.1	–1.8
Outlays	120.2	120.2	—
Total:			
Budget Authority:			
Option 1 (RR method)	143.4	146.8	+3.5
Option 2 (nominal outlays [a])	143.4	149.5	+6.2
Outlays	177.1	182.4	+5.2

PRESIDENT BUSH'S BUDGET—PRESENTED IN BUDGET SUMMIT FRAMEWORK—Continued

(In billions of dollars)

	1989 February Estimate	1990 Bush Budget	1990 Bush vs. 1989 Est.
Mandatory:			
Naturally Declining:			
Outlays	51.9	41.9	–10.0
Structural Reform: [b]			
Outlays	104.2	105.9	+1.6
Freeze:			
Outlays	10.2	10.2	—
Others:			
Outlays	376.7	386.9	+10.2
Total (excluding double counts):			
Outlays	526.4	529.1	+3.2
Asset Sales and Prepayments:			
Budget Authority	–0.9	–1.4	–0.5
Outlays	–6.9	–3.6	+3.3
User Fees and Other Collections:			
Budget Authority	—	–5.2	–5.2
Outlays	—	–5.2	–5.2
Interest:			
Budget Authority	168.8	173.3	+4.5
Outlays	168.8	173.3	+4.5
Undistributed Offsetting Receipts:			
Budget Authority	–36.9	–36.9	—
Outlays	–36.9	–36.9	—
Total:			
Outlays	1,143.0	1,156.8	+13.8
Receipts	979.3	1,065.6	+86.4
Deficit	163.7	91.1	–72.6

[a] Freeze option 2 is a nominal outlay freeze at the account level.

[b] Includes portions of GSL and farm support payments counted in "Naturally Declining," and FEHB reform counted in "Domestic Discretionary—Priority."

Chairman Sasser.

You are critical in your opening statement of the "Wonderland" nature of the traditional current services budgeting approach that has traditionally been used. Of course, the current services budget approach came into being as a result of continuing inflation; it is really a means of guaranteeing the real purchasing power of the appropriated dollars at the end of the line.

But now, as I listen to your statement, I am a little concerned or confused about really what amounts to a freeze in the proposals that have been advanced by the Administration.

First, we have the straight outlay freeze that is in programs in the so-called "black box" or "pot" or "black hole". Spending for these programs, which are almost exclusively on the domestic side of the budget, are frozen in 1990 at their actual 1989 spending levels. In other words, you are going to get the precise amount of dollars in 1990 that you got in 1989, even though there may be an erosion of 4, 4.5 percent in the purchasing power of those dollars. We call that a "hard freeze".

Then, we have the current services freeze in the Bush budget, which you have criticized here this morning. This type of freeze acknowledges that there are costs in some programs that grow from year to year due to inflation and other special needs, and the President's budget—to his credit—puts social security and a number of the means-tested programs in this characterization. And this is the current services freeze.

Then we have a third freeze, which I will characterize as the "Pentagon freeze". The defense budget is allowed to grow by the rate of inflation, so in nominal terms, it is really growing by 4 percent. Then we add on to the defense budget a "plus", an additional $2 billion, because of a savings windfall resulting from an accounting change in military retirement.

Now, Mr. Darman, why should we accept the administration's proposal here of three separate kinds of freezes? I must say to you in all candor that I am now beginning to understand what the term "flexible freeze" means; it means you have the ability to flexibly freeze various and sundry programs what ever you like.

But tell us why we on the committee should accept that concept and go into a discussion on that basis?

Mr. Darman. Senator, I do not think, if I might just jump to the last part of your question, that you should necessarily accept the concept. I do not think I would be successful in trying to persuade you to. But I will predict that in the end, whatever we talk about conceptually, the practical application will be flexible.

In other words, we could have a discussion for 3, 4, 5 hours here about budgeting concepts; in the end, I would bet that the behavior—even if the Administration had absolutely nothing to do with it—would end up looking somewhat flexible. And in my opinion, that is not irrational.

But if I might just address a couple of elements of the earlier part of your question, rather than try to get into a definitive debate on the concept. If I could ask that you consider Appendix F in my testimony, which is entitled, "President Bush's Budget—Applying the Residual Freeze", it, I think, makes the point that you were making, that it is indeed the case that "freeze" is defined differently and applied differently in different categories.

And you will note, as you suggested, that there is a freeze applied in nominal terms to non-defense spending—that is, 1990 levels are at 1989 levels—for what we refer to respectfully as the residual category, and you have three other labels for.

There, the dollar growth is zero, and the percentage change is zero. We then also propose—and you did not mention, but I know that you are well aware—to freeze Federal retirement COLAs. And in that case, we are freezing the COLAs, but because of the growth in beneficiaries, there is a dollar change, a positive amount, plus $1.5 billion, which amounts to a percentage still of a growth of 2.9 percent.

And finally, if you look at the defense number, what we have frozen is defense budget authority at zero real growth. And of course, our presentation has been in terms of outlays. Translating the budget authority freeze into outlays produces these numbers: in 1989, $289.8 billion; in 1990, $291.2 billion—for a dollar change of only $1.4 billion; a percentage change of 0.5 percent.

Now, something missing from this table that you correctly referred to. We could say—and did not—that we have a current services freeze on social security and means-tested entitlement program, which we do; then, we would have another very big number here with a very big growth level associated with that.

But in any case, on defense, if you switched to common terms, if you said make the rule for defense the same as the rule for the residual category, it would be a change of a grand total of $1.4 billion.

Senator DOMENICI. In outlays.

Mr. DARMAN. In outlays—which is the way in which it is being applied, if we insisted on common application—or, look at it the other way around. If we took the $136 billion residual category, and we said let us adjust that upward for inflation, it would grow by a little less than $5 billion.

So if we were to make these categories exactly consistent with each other, we really would not have a terribly large difference. I am not saying it is inconsequential; it is consequential. But it is not on the order of magnitude of double-figure billions; it is a small amount.

One last point, if I may. You referred to, I think, an accounting—did you refer to it as an accounting windfall—as the way in which we calculate our defense real growth number? I think what you are referring to is a change in the way that retirement accrual is handled in the budget.

Chairman SASSER. That is correct.

Mr. DARMAN. Could I just suggest to you how at least we moved from the 1989 budget authority level in defense of $290.2 billion to the 1990 budget authority number of zero percent real growth at $299.3 billion?

We subtracted $18.4 billion for the retirement accrual, which would then give us a baseline in 1989 of $271.8 billion. We then added back the 1990 retirement accrual, correctly calculated as determined by the actuaries now and revised at $16.2 billion. We then put in the military and civilian pay raises at 2.4; the 1989 pay annualization at 1.1; and pay-related inflation changes at 1.0; and then for the remainder, the non-personnel portion, purchases, we inflated them with our inflation rate, which adds $6.8 billion, that gets you up to $299.3 billion.

So I do not think there is accounting gimmickry in it, although maybe this is a matter we should leave for further debate among technical analysts.

Chairman SASSER. My time has just about expired, but Mr. Darman, let's go back to your defense budget. You are saying that your outlays increased by what, $1.6 billion?

Mr. DARMAN. By $1.4 billion in the 051 account.

Chairman SASSER. OK, how about budget authority in this fiscal year 1990 budget; isn't that increasing at $10 billion a year from year to year?

Mr. DARMAN. Yes; it is increasing at a little over $9 billion.

Chairman SASSER. My point is this, then. The Administration comes to us, and it is quite specific about the amounts that are available for defense; it is quite specific about the amounts that are available for some of the other entitlements; it is quite specific about a number of the other domestic and international add-ons that the Administration considers to be of high priority, and some of which I would agree with and some of which I suspect a majority of this committee would agree with. But it appears to me that you cannot have it both ways.

I do not see why we should accept some of your proposals for defense or entitlements, and then you do not make any proposals for the $136 billion worth of programs in the so-called "black box". In other words, we have an administration here that wants to embrace the concept of a "line item veto", but does not want to give us a "line item budget" on the question of the programs in this $136 billion "black box". That is the real sticking point, and that is the problem.

What do you say to that, Mr. Darman?

Mr. DARMAN. Well, I would have a couple of comments, Mr. Chairman.

One, we have provided a document that looks just about like this—this is almost the exact document—with the $136 billion broken out account by account, with three different options for each account, all of which would sum to the right level.

One of the options would be the Reagan policy; another option would be just a nominal freeze—we do every account next year at the same level as this year—and a third account, we identified as "to be negotiated".

Now, my opinion is that we can debate this issue for any length of time, but in the end, we are going to be operating in the "to be negotiated" category. Whether the administration is involved or not, the Congress will be operating in that category.

Chairman SASSER. But we might negotiate different things with each other than we would negotiate with you.

Mr. DARMAN. Well, that was the second point I was going to get to. Perhaps I should confess to being—I could characterize it as "appreciative" of the large degree of interest that some in the Congress are now showing for the Administration's proposals in this area. In prior years, having received them, it was very hard to ever get them attended to. The success rate with Administration proposals in these categories in the past is about as close to zero as you could have. It is not as high as you would likely have with just a random process.

Chairman SASSER. My time has expired.

Senator Domenici.

Senator DOMENICI. Thank you very much, Mr. Chairman.

Mr. Darman, let me suggest that I do not have the same kind of problem with the discretionary category as others might have. But let me suggest that maybe for purposes of clearing the air, I might suggest that one mistake has been made by way of semantics.

I do not think you ought to call defense a "freeze" if you add inflation, and call the discretionary category a "freeze" if you do not. I really think you ought to just explain that defense is a priority item and we have added inflation to defense. When we finish with all of the priority items, there is a residual for the rest of the programs that is literally frozen. I believe that semantics might have been helpful, and I urge that you not try to make the two freezes the same, because you have got to go ahead and explain it anyway.

Now, having said that, let me suggest that I understand the difference between adding inflation to defense and not, because that is a priority item of this President, and he contends that in order to adequately maintain the national defense, we need to add at least inflation to last year's budget in terms of budget authority, and that yields $1.4 billion in additional outlays if I am correct. Is that right?

Mr. DARMAN. Right.

Senator DOMENICI. Is that why you understand defense will be at a level that is what the President, meeting with his experts, said we need as a bottom line for defense?

Mr. DARMAN. That is partly why. I think that the President and the defense community would have preferred a higher level if it were being evaluated strictly in terms of what is needed for national security. But the President felt that in the fiscal context we find ourselves in, that it was important that there be some contribution made to the adjustment process by defense, and so this level is not as much as I think the defense community would feel were appropriate for national security purposes. Inflation adjustment as they see it would not be sufficient.

Senator DOMENICI. All right. Now, Mr. Darman, do I understand that after you have done that, there is another category of Federal programs, and you call these this President's priority programs you have decided how much is needed for them, such as homelessness, and you have decided that the McKinney Act should be fully funded. That is clearly stated in your proposals as the priority items of this President. They are dollar amounts which anyone wants to look at; they are measured compared to this year's expenditure in budget authority and outlays as priority items. Is that correct?

Mr. DARMAN. Yes.

Senator DOMENICI. And there are a number of them—I just gave you homeless; there are others.

Mr. DARMAN. Yes. There is quite a list of them at Appendix B in my testimony. And if I might just note, Senator Domenici, if we were looking at all non-defense discretionary programs as a group, those initiatives would have to be added to the programs that are frozen in the terms you defined, and so we would then find that the group as a whole were increasing very substantially more than defense.

Senator DOMENICI. And isn't it based on the history of the way we have conducted business, even if you recommend $1 billion for homeless funding, it is in that discretionary account, and the appropriators will decide whether it is a $1 billion increase or $350 million—that is the way we have done it over all these years from President Reagan's budgets or any budget you have been a participant in. Is that not correct?

Mr. DARMAN. That is correct, and indeed, the level of detail that is being asked of us for this period in the budget process for this committee process, the Budget Committee process, oriented toward a budget resolution, has previously been, I would say—well, it is at a very, very, very much lower level of abstraction than the Budget Committee has ordinarily dealt at, number one. And number two, I think it is in the domain that the appropriations committees would properly consider their own, ordinarily—I am not about to get into the middle of that argument; I am just noting as a matter of history.

Senator DOMENICI. Well, let me just finish here, and I will try to hurry.

When you have finished adding on to the priority programs that you recommend as contained in the index that you have just described, you then proceeded with entitlement programs, and you told us where you thought we ought to save money and then where entitlement would increase automatically. You arrived at a conclusion that in order to meet the Gramm-Rudman targets, the rest of Government had to be frozen year over year, 1989 over 1990.

Now, had it come out that in order to reach the Gramm-Rudman targets that they all had to be cut 1 percent, that is what you would have shown in your budget—do I understand you correctly?

Mr. DARMAN. That is the analytical process we went through. We might have done that, or we might have decided that we should go back to the priority spending area and say, "Let's lop something off." But I do think it is a useful way to proceed analytically to first try to get straight what are your priority interests and treat some portion of the budget as a residual, a portion that is not so high priority from the Administration standpoint. Obviously, others have different priorities, and that is why it ends up having to be negotiated.

Senator DOMENICI. Now, let me just ask two more questions. In the list of frozen programs in the discretionary category, you have included two items that I wonder about. You have some mandatory expenditures in that list, such as Postal Swervice and others. Why are they in the discretionary total?

Mr. DARMAN. In retrospect, I think it was a mistake; that we should have grouped all mandatory together. It would have made things less confusing. I think that they are in there because the analytic process we went through was exactly the one you described, and some of the mandatory programs were in the left over category, and so we applied a nominal freeze.

The more logical way to look at the mandatory segment is probably the way the budget summit group did—all in one pot.

Senator DOMENICI. Right. So would you provide the $136 billion residual minus the mandatories, and list them for us. Also, you have a defense item in there, which is "defense/nuclear"—I assume that that has the same rationale—would you remove that for purposes of something we can look at. I assume that defense residual would be included in the overall total of defense that we have been talking about here today; is that correct?

Mr. DARMAN. You would have to add it to the totals that I have been giving. It is in a different account. I was using the 051 account.

Senator DOMENICI. But if it is 050, it would be in there.

Mr. DARMAN. For the 050 account, it should be added. It is $120 billion. We have already done that for the staff.

Secondly, I just might add a point. On the defense category that you are interested in, a portion of which is in the residual freeze pot, it is not our policy preference to fund it at the nominal freeze level. The nominal freeze numbers that have been provided staff to staff are just a mechanical application of a nominal freeze.

Senator DOMENICI. I thank you.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

Senator Hollings.

Senator HOLLINGS. Mr. Darman, you and I had the pleasure of getting together, and I told you my view that the ox is in the ditch, that we are in serious economic trouble. I realized the President had said no new taxes, and I thought the way to get around it was to ask the Congress for a line item veto, and then when they did not give it to him by March 1, come up with a revenue program.

I go back to 1980, after President Carter had lost. I went to the White House as Chairman of the Budget Committee and said, "Mr. President, you are going to leave a bigger deficit than you inherited from President Ford."

He said, "How much is that?"

I said it was $66 billion.

He said, "How much is it projected to be?"

I said, "The Congressional Budget Office says $75 billion."

He said, "Heavens, we cannot let that happen."

And as the Chairman of the Budget Committee, I answered with the first reconciliation bill, went to my liberal Senator friends—Magnuson, Culver, Bayh, Church, McGovern, Gaylord Nelson, right on down—and I said, "Look, this will be disastrous if the Democratic Party comes in with the biggest deficit, $75 billion."

The point I make this morning is that we do not fear deficits as much as we fear the next election, and you are advocating a conspiracy, or what you call a negotiation, to hurry and come up with a 2-year budget to get us by next year's election, just like that sorry 1987 summit agreement got us by the 1988 election.

I say "sorry summit agreement" advisedly. Under the original Gramm-Rudman-Hollings, the deficit this year was supposed to be $72 billion. It is now at $300 billion. Now, let me remind you how we pretend to reduce that $300 billion deficit. You start with a projected deficit of $164 billion. You shift $11 billion from the savings and loan crisis into the 1989 deficit. That brings to $175 billion. You steal $125 billion from trust funds. So we are spending—I am looking at it the way the financial markets look at it—we are spending $300 billion more than we are taking in right this minute. And the different programs have come forward. You say they are not immortalized. But we now have a Republican President harping on child care and education and research, environment and what-have-you. You all have immortalized these programs as much as anyone else, when you list them all down as great needs—and we agree with you, you see. Bipartisanly, we agree on all the spending, and bipartisanly, we agree against taxes.

Specifically, with these things coming forward, you have health care for 37 million Americans. That will cost at least $15 billion. You have got the nuclear waste; Government Ops said that will cost $147 billion. You have got the S&Ls; your own plan costs $154 billion. The interest cost right now is $182 billion, and those costs are jumping in increments of $17 to $20 billion per year.

We can fiddle around here in negotiations with a little bit on cigarettes and 5 to 8 cents on a gallon of gas, and get $8 billion, and end up with $11, $12, $15 billion—and the interest costs are jumping faster than what we can save.

I just do not see this as a serious initiative. In all respects, you are more "Jack-be-nimble" than Stockman. You all must think, or President Bush must think this is still a covert operation or something, the budget is, and we cannot catch the budget. We have got the "Phantom of the Budget" now from you this year, and we cannot find it, and we cannot catch it, and you say, "Come on over to the White House, and we'll let you in on it." And the dummy Democrats will go over there with you, and once they agree, then they will have the responsibility of "leading" the President's budget, and when the collapse comes, the White House will blame us. I am going to stop playing that game.

Specifically, I tried to add up the President's numbers. One point you made—that we will have $80 billion in new revenues in 1990. The Congressional Budget Office says $13 billion of that is soft. This is the last year of the implementation of the 1986 tax reform. So that is a very soft figure. Five billion is from catastrophic insurance and $5 billion is from social security. So actually, we do not have that $80 billion.

A truer figure, if we are looking at it as budgeteers, is around $65 billion. The fact is, look at the following year. The following year we find out that new revenue goes down, according to CBO, in 1991 to $71 billion, and that is using $6 billion from catastrophic and $6 billion from social security. So they are looking the following year at new revenue of $59 billion. So we had better not start talking like my colleague from Texas, Senator Gramm—"Oooooo, look at all the billions we've got to spend"—like this is one, grand spending party.

Now, to these savings. I turned to page 4, and I started adding up how much you want to spend, because you have been good at telling us what you want to spend, but you have been totally incapable of telling us how you are going to pay for it—except that there are not going to be any taxes.

Investment in research and development, biomedical, space and Super-Collider—that is at least $2.2 billion. Investment in education, even the Reagan budget came up $4.5 billion, with child care at $2 billion.

Investment in protection of the environment is $1.5 billion. Investment in combatting drug abuse is $1 billion. Housing is $1 billion. That inflation increase for defense is $7 billion. Social security will increase by $16 billion. S&Ls is $2 billion in interest costs, and will probably be more if you cannot shift it. Health care, yes, you cut $5 billion from $19 billion, but that is $14 billion.

So I am adding up over $50 billion you want to spend—or President Bush does—in that budget wish list that he sent up. And you say you can reduce the deficit by $60 billion. Well, that is a $110 billion swing.

Mr. Darman, you would flunk first-grade arithmetic. Your numbers don't add up. You cannot do it without taxes. Once you take taxes off the table, you have got to fabricate. And what you are doing is inviting the Congress to come over and fabricate with you, like we did in December 1987.

We said then that the deficit was going down to $136 billion; but it is now up to $164 billion, and is probably going to be $175 billion. Gramm-Rudman-Hollings is not working. It worked in the beginning, but it is not working for the past 2 years. Certainly, Reaganomics is not working. We are growing into the biggest deficit, spending $300 billion more than we are taking in, right as we are seated here in this hearing room.

It strikes me that you would have a plan of some kind. I have suggested a freeze on outlays, right across-the-board—take last year's budget for this year. Any mayor of any city, if it ran out of money, would take last year's budget. By following that practice in Washington, we would save $36 billion.

I have suggested a 5 percent value-added tax to bring in $70 billion to go into a Deficit and Debt Trust Fund over at Treasury, absolutely to be spent on nothing other than the deficit and the debt.

Now, my hope there, if you want to know it, is if I can save $15 billion to $20 billion in interest costs bringing that debt and deficit down, I will have something for cleaning up the environment, I will have something for the savings and loans, I will have something for education, research and child care.

But you have got to get hold of it right now—not when the collapse comes.

I have suggested a line-item veto. Take the example of drug abuse. We passed and President Reagan signed $3.5 billion after the big Omnibus Drug Act we passed last year. But we can only find $500 million to fund it; we are looking for $3 billion more. You say you are going to spend one more billion with the czar. We are going to put two more billion in there; we are going to put $3 billion into the drug war. We are not going to cut that war because we need it. And when we need it, on a line item veto, go ahead and veto it. If President Reagan says it is needed, and President Bush wants to veto it, I am ready to play that game. I am ready to fix the responsibility and to quit playing the game of getting past the next election, because we have got serious problems in this government.

I do not know how to characterize this plan of a little bit of freeze over here, and no freeze over here. You have got the "black box", and you challenge us to find it. The 82 items that President Reagan listed, we factored them out at $4.9 billion. That does not do it. And $9 billion in cuts if you took all his cuts; if you took all of his eliminations, the 82 programs, you would end up with only $14 billion—and interest costs are going up at least $17 to $20 billion—if you took his whole budget.

So you cannot seriously claim to meet the Gramm-Rudman-Hollings target, and talk about reducing the deficit while in fact you are spending another $50-some billion.

I would like your comment. [Laughter.]

Mr. DARMAN. Thank you very much, Senator Hollings.

There are, as you appreciate, a large number of things to comment on, and I will try to do it quickly.

First of all, on the notion of a conspiracy to get by the election, I think you also said a conspiracy to get the job done fast. I would plead guilty to the latter, a conspiracy to get the job done fast. I would not use the term "conspiracy", but I do think we——

Senator HOLLINGS. Is it your idea that we eliminate the Congressional Budget in this committee?

Mr. DARMAN. No; but I do——

Senator HOLLINGS. Well, then, who is going to come over and do the negotiating? We have not had a chance to have hearings. You are our first witness.

Mr. DARMAN. No; I am not suggesting that we agree today——

Senator HOLLINGS. When do you want to start the negotiations?

Mr. DARMAN. Well, I would like us to do whatever it takes to meet the targets that are in the law. I would like to see a budget resolution agreed that can be implemented by April 15th.

Senator HOLLINGS. Well, when do you want to start the negotiations?

Mr. DARMAN. Well, obviously, we are ready immediately. But I think that as a matter of fairness to the process that the Congress has to go through, we need to go through this testimony period here and then presumably start to be a little more serious about where we really are.

Senator HOLLINGS. I am serious as we can be right now. I do not like taxes, either. I have yet to find anybody who does. But you know, it is a paradox—you actually have to raise taxes in order to cut spending. If I raise taxes and put it in that trust fund, I can cut the interest cost spending that is going up faster than anything else in the budget. And that is what everybody in America has got to understand. We actually have worked our way into a position where we must raise taxes in order to cut spending.

Mr. DARMAN. Well, if I could just add one point to the issue of getting the job done fast. I do think that there is a political consideration here. I think we could get a better agreement this year than we will get next year, and for exactly the reason that you suggest. I think that the political system is more likely to come to a responsible agreement this year, fairly soon, than it is if this drags out.

I also think that if this drags out, there are market risks, as I suggest. So I think there are plenty of good reasons to try to get this going quickly.

On the issue that you raise about trust fund accounting, I agree with you. I think that the trust fund accounting is misleading to ourselves, and——

Senator HOLLINGS. And I put in a bill to take social security completely off budget, where you cannot use it in estimating of your deficit, and you cannot use the funds period. We are using $68 billion from the Social Security Trust Fund to get down to that $164 billion.

Mr. DARMAN. I agree with you about the problem, and your point about accounting—although not exactly your solution—although I think, with some further conversation, we might even be able to find a way to agree on a solution. But what I wanted to emphasize is this. The Gramm-Rudman-Hollings targets were designed with full knowledge of the contribution being made to the consolidated budget deficit reduction by the inflows in social security and other trust funds. That is no mystery. That was in law. It was already taken into account when the targets were established.

So if one wants to change the accounting system so that we more fully and timely——

Senator HOLLINGS. You can change the targets.

Mr. DARMAN [continuing]. Yes; and the reason that I think that, while that is correct analytically—this is just a personal judgment about politics, and obviously, you are more expert than I—but my personal opinion is it would blow the current system apart; that if we had to suddenly change Gramm-Rudman targets and enter into a big debate about what is counted in and what is not counted in before we get down to business on a serious substantive agreement, that we will end up in months and months of arguing about what to take out of the process without it being very reassuring to financial markets. And in the end I am not at all sure that we would end up with a more disciplined system of the type that I think you would want.

So that is a political judgment. My personal view is that we ought to make the changes you have in mind, but we——

Senator HOLLINGS. Now, Mr. Darman, you are from the financial markets. They know what I am talking about. And I am trying to look at it the way the financial markets look at it.

Mr. DARMAN. Sir, with respect, if I had not spent the time there I have spent, I might agree with you. They pay a lot of money that I would not have thought they should have to pay, to people to be down here, watching what we all are doing, trying to figure it out—and I do not believe they fully understand. And they come to understand these things through some extremely simple indicators. One of the simple indicators is the Gramm-Rudman targets, which have taken on a certain special status that one might not have thought they would have, but they do.

Chairman SASSER. We call them "Gramm-Rudman-Hollings" targets around here.

Senator HOLLINGS. And you can disabuse——

Mr. DARMAN. Yes. But I had the sense that Senator Hollings was dropping his name from the targets.

Senator **Hollings**. Yes; Gramm-Rudman-Hollings is a shield out there that we are all hiding behind, and it is not working, I can tell you.

Mr. **Darman**. Well, what I wanted to suggest is this. I agree with your analysis about the accounting problem, which is more than an accounting problem—ultimately, it is a real problem. My personal view is that a better way to proceed is to try to reach agreement on a substantive package and to insist among ourselves that after we have done that, we then have an agreement on some changes in Gramm-Rudman to make the accounting better, and some changes in budget process itself, like line item veto or enhanced rescission.

It is just my personal judgment that if we start out trying to get those things, we will not; and we have got to get the substantive agreement first. Then we are in a position to tell financial markets, "Here is what we are doing substantively, and now here is the way we are changing the accounting."

Senator **Hollings**. My whole thrust is to stop playing games, and I do not mind which comes first. I take your point. It is well-taken. I am saying let's stop playing all the games, use honest CBO figures and not these funny interest and growth rate figures that you have been using; similarly, let's by gosh put everything on the table, and let's put out a revenue program that will stick and begin to at least take care of the interest on the debt. And I think the American people will support a tax to get rid of the deficit and the debt.

Thank you very much, Mr. Chairman.

Mr. **Darman**. Could I add one comment, Mr. Chairman?

Chairman **Sasser**. Go ahead, Mr. Darman.

Mr. **Darman**. A small point on the order of a footnote. When you use the phrase, "honest CBO figures"—I do not doubt the honesty of CBO, nor do I doubt the honesty of OMB's career people in this process. I would underline the point made in my testimony, and it can be backed up in 100 more ways than shown there, that CBO is often wrong as well. The real problem is that the science itself is not a science, macro-economics. That is a footnote point.

But a second and larger point. You referred earlier, Senator, to this process as if we were looking at some strategy to be able to get the Democrats to take blame, and the Administration to be in a position to take credit. I have read a lot about that in the newspapers, and we are giving credit for a little more wisdom on this subject than we deserve. I would just note we have had a couple of favorable examples in the past in which I have participated. One was the social security compromise, where everybody thought it couldn't be done because there was nothing to do that you wouldn't get blamed for—it was either going to come on the tax side or on the benefits side, and neither one was attractive. But the system ended up coming together through a process of negotiation on an agreement on which nobody was blamed. We worked it out so that everybody was able to step forward together and take credit.

Another example—here, there were not quite so many people who were enthusiastic about being associated with it—was tax reform. It did come out of the Senate Finance Committee, 20-to-nothing. It had an overwhelming vote, ultimately. It had a high degree of bipartisan support. And I think there, there was plenty of room for people to take credit all the way around.

If we in the end do what is right here, part of doing it should be that we do it in a way that there is no distribution of blame according to partisan lines. We do not have any interest in organizing a process that is going to result in one group being blamed or another group being blamed. I hope we do what we can do on a bipartisan basis so everybody can take credit, and there is a minimum of blame to be spread around.

I would say the social security agreement——

Chairman SASSER. Well, Mr. Darman, we learned a long time ago——

Senator HOLLINGS. The only fear we have to fear is a lack of fear around here. That is the trouble. We are not afraid of all these things impending on us.

But thank you very much, Mr. Chairman.

Chairman SASSER. Mr. Darman, we learned a long time ago around here to let the distinguished former Chairman of this committee, Senator Hollings, have the last word. So I would advise you to follow that procedure today.

Senator Grassley.

Senator GRASSLEY. I think under the rules, you have to let Senator Symms go ahead of me.

Chairman SASSER. Well, I am following the list given us by our distinguished ranking member here, and he has got Senator Grassley next.

Senator GRASSLEY. I guess that gets back to the question I was asking—if you are going to follow seniority—

Senator DOMENICI. It is arrival time; we made a mistake.

Chairman SASSER. All right. Then, Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman.

Mr. Chairman and my colleagues, the first thing I would like to say to Mr. Darman is that I agree with him that the "current services" budget terminology misleads the American people about what is going on in fiscal decisions.

I also want to say to Senator Hollings that I agree with a lot of what he said. I remember very well that 8 years ago, when I was a new member on this committee, that I was dumbfounded to find out that we always talked about some fictitious number out in the future and then talked about cuts from that number, and never talked about last year's number and this year's number in respect to the budget.

I remember that Senator Hollings offered an adjustment to the COLAs for 85 percent of the CPI, or the Wage Index. Had we accepted that, and had President Reagan gotten on board with that, we would have balanced the budget by now, in my opinion, and it would have solved a lot of problems. But that is history; we did not do it.

But I do think it is important—and I would turn the twist on what Senator Hollings is saying here— in my view it is what the government spends that is important. Whether we borrow the money, tax people for the money, or let the Federal Reserve print the money, the end result is that the Government is growing, and the private sector suffers from an erosion of capital that has to go to Government services. I am talking about, for example, we pay people thousands of dollars to put little radios on bears and follow them around in the woods, in my part of the world. The wolves now are the new thing. And people who are in debt to the tune of trillions of dollars do not normally spend money on projects like that, but Congress just spends it. You go out and see the ranchers out there, and they are driving old, beat-up pickup trucks, trying to survive. You go down to one of the Federal land management offices, and you see those new pickup trucks, four-wheel-drive, all lined up in the lot. And you walk in, and they've got a hydrologist, an archaeologist, or whatever you think of, up and down in a row, filling out papers about what it is they are doing out here—but the end result is they let fewer people graze cattle on the land, fewer people mine on the land, less recreation on the land, and less timber harvested from the land.

I know the Senator from New Mexico could say the same thing is probably true in New Mexico. So there is plenty of money being spent by the government, that is my point.

What I would like to have you do to put this in perspective is give us some numbers for Federal revenues in 1980 when I went on this Committee, and where are they today—give us the numbers. Give us some of the spending increases by different categories—how much we were spending in 1980 and what we are spending now. It has always amazed me to go back home during the Congressional recess breaks during the 8 years that Ronald Reagan was President and have all of the questions coming at me from the local media people, who get their information from the people here in Washington who put the news out, about all those Reagan budget cuts.

And I find it very difficult to understand—where were the cuts? If we had a half-billion-dollar budget in 1980, and it is a $1.2 trillion approximately in 1989, where were the cuts?

Would you give us both the change in the revenues and examples of some of those functions?

Mr. DARMAN. We have a whole volume of historical tables which we just published, which I do not have with me at the moment, but I am seeing if I can get, which has got the answers to those questions and more than you would ever want to know on the subject. So if you could just——

Senator SYMMS. I do not want to know too much. I would just like to hear you say for the record, so maybe we could get it reported out here across America that we really have spent more money; that government has not shrunk; there were not cuts under the Reagan years; there was increased spending.

Mr. DARMAN. At an abstract level, that is certainly true.

Senator SYMMS. How about revenues?

Mr. DARMAN. Revenues also went up substantially; but the gap obviously has risen, and that is the deficit.

Senator SYMMS. So what do you think about the thesis of my statement, that how much the government spends is more important than how much we borrow or tax or print?

Mr. DARMAN. I think they are both important, but I think at the moment we ought to be looking on the spending side.

Senator **Symms**. If we really would hold the line on spending, do you think the financial markets would react correctly.

Mr. **Darman**. That is the premise of this budget.

Senator **Symms**. What would your opinion be if this budget were passed immediately; what would the impact be on interest rates?

Mr. **Darman**. I don't think there is any serious threat of that happening, but if it did, I think the effect would be very favorable. I am not necessarily a credible judge on this point, of course. I would refer you to the chairman of the Federal Reserve, who has said—and is testifying again this morning—but he has said that if a budget of this type were passed—he did not have in mind immediately, but he had in mind soon, in the ordinary process—if it were passed relatively promptly, he has said that he would expect interest rates to come down sharply; and that, too, is a premise of our budget.

Senator **Symms**. I have heard him say that, and I think it is important we recognize that if we did accept this budget and pass it, probably the effect would be very positive and very favorable on interest rates.

There is another question I would like to ask—and I will try to reduce my time, Mr. Chairman. I was watching Mr. Darman on television from my office at the opening of this hearing this morning, and I was later than some of my colleagues getting here—I would like to ask you to comment on the capital gains tax proposal, the reduction in capital gains rates. Historically, we know that the reduction in capital gains rates will increase revenues to the Treasury. Why is that not figured in the budget?

Mr. **Darman**. It is figured in the budget. We do have an increased revenue from capital gains that amounts to $4.8 billion, I believe, the first year and declines a little thereafter to a smaller amount.

The argument should be not whether the capital gains number is in there, in my opinion, but whether it adequately takes into account the favorable effect of future growth. Let me explain something that might be slightly confusing on this.

I have said publicly that I thought——

Senator **Symms**. Well, you did not use it to meet the Gramm-Rudman-Hollings targets.

Mr. **Darman**. No, we did not use it to meet the Gramm-Rudman-Hollings targets. That is because if you notice that even without our capital gains assumption, we still have enough projected spending restraint relative to the revenue increase so that we exceed the Gramm-Rudman target, even without the capital gains adjustment.

The capital gains estimate that we have made is a positive number, and what we were trying to do there is to say, look, we are well aware of the big debate that is taking place on how you estimate capital gains; so in order that we can get capital gains addressed on its own merits, let's put that aside, and do not be using it to make the Gramm-Rudman-Hollings targets, because we think we can get a more fair debate on the capital gains issue if it is not tainted with the accusation that it is being used as a phony device to meet the targets.

That is a comment I have made publicly, and maybe that is where this confusion arises. We do have a positive revenue estimate associated with our capital gains estimate. It is just not necessary to meet the Gramm-Rudman target.

Senator **Symms**. Thank you very much.

Chairman **Sasser**. Thank you, Senator Symms.

Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Mr. Darman, I am glad to have the opportunity to talk about a few things here. Because the attendance here at the table is so large, I would like to narrow down some things I would otherwise like to discuss with you, some of which Senator Hollings discussed, and few of us have his facility to characterize things so colorfully. But we are going to be in, I think, some disagreement on a few things. I would like to discuss environment and infrastructure, if I might.

We talk about a kinder, gentler society. If we adopt the initial budget presented to us, we are talking about a drop of $1.2 billion from the authorization level of clean water sewage construction grants. That to me does not sound kinder or gentler; it sounds dirtier and harsher.

We talk about investing in the future and yet talk at the same moment about cuts in mass transit spending and Amtrak, which some of us feel are essential to the areas in which we live.

I wonder how we are going to deal with those things. Mr. Darman, I heard you talk about your willingness to negotiate. But if we start with the proposal that was laid down initially, the negotiations are going to be entirely uphill, and I do not see us coming to the point where I would like to see us, focusing now on transportation and environment.

Do you have a position that you would like to declare now on how we can invest in our infrastructure, and how we can improve our environment, given the kinds of cuts that have already been presented to us?

Mr. **Darman**. Well, let me take the environment first, Senator Lautenberg, if I might.

So far, I might note—and I appreciate your criticism—but I might note that many in the environmental community have expressed to us their appreciation for our budget. This is unusual for those of us who were, for many years, in the Reagan Administration. And I would just note that their characterization, at least in the experience I have had so far, would not be identical with yours.

For example, I think environmentalists are extremely appreciative of the decision to delay OCS leasing off the coast of Northern California, Southern California, and off of Florida insofar as it affects the Everglades—and that is about a $500 million revenue loss, or revenue that is foregone, associated with that. That is not a small amount of money invested in environmental protection, if you wish to look at it that way.

With respect to acid rain, we have a substantial increase in investment to deal with clean coal technology, and we have also said that we would come forward with a new clean air bill promptly which, for many, many years was not done in the Executive Branch, and the Congress to some extent fought with itself, and nothing much happened. I think with our moving on that, it will make it easier to reach agreement on a clean air bill, which is not insignificant.

Atomic weapons production and cleanup—we have made a start in that direction. Senator Hollings is right—the long-term bill is going to be enormous. But the long-term actions cannot all be taken at once. We are doing about as much as you can do in the very next year, quickly, and we are funding that.

Now, there are others I could mention—the wetlands regulatory action. It would be our proposal to expand Superfund expenditures. But you are right that, yes, there are some other areas where we have taken some positions which are not in favor of increases; they are in favor of decrease. And it is ironic that we are said to be in a situation where we are not willing to talk about any cuts, and at the same time we are criticized for our COLA freeze and our medicare cuts and a whole long laundry list of cuts, including a couple you have just added, and that I am happy to confess to.

The clean water sewage construction grants in all probability, in the negotiations, we would come out with our initial position in the way suggested in our book—there would be a substantial reduction in that account.

Now, I would note that originally, in 1972, as I understand it, the program was supposed to be an $18 billion program; the Federal money was supposed to be seed money in a much larger project. Since then, we have spent $50 billion at the Federal level. There is some point at which the $18 billion commitment can be said to have been fulfilled—and one can get into an argument about what is the proper role of Federal versus State and local in this area——

Senator **LAUTENBERG**. Yes; Mr. Darman, I do not want you to use all my time, and I am sure you do not intend to do that, but so far we have succeeded in reversing roles here.

Mr. **DARMAN**. I am trying to answer the question.

Senator **LAUTENBERG**. I know, but let me say this—although we talk about potential savings for not drilling in the coastal areas of California, we do not know what kind of a clean air act we are going to be looking at. We do not know whether we are going to need some pretty substantial funding, whether or not we are going to be able to pass that off to the local communities or the States. We have got a lot of work to do, and I don't see how your budget's proposed funding level for environmental programs will be sufficient.

You know, coming from the area that we do, that the sewage construction grants have helped quite a lot. The Hudson River is now going to be swimmable from the point north where the New Jersey-New York border meets; they are going to start shellfishing there in the Raritan Bay. There are a whole bunch of things that have happened. But we are not looking back at 1972. We are looking at a much more recent period, when we in the Congress overrode a veto to spend $18 billion over a period of time at the rate of $2.4 billion a year, a mix of both loans and grants. We are not coming anywhere close to that.

So, although we could spend some more time arguing this, I do not really think we are going to be able to accomplish the environmental goals with your budget.

What the Administration has done so far—the best thing they have done so far—is appoint Reilly the EPA Administrator. But we have not seen anything in this budget that gives me any comfort that we are going to be able to deal with the environment or the infrastructure in an appropriate way.

Mr. Darman, in 1986, I consider that this Congress and the country went through a wrenching tax reform experience. The negotiations were very tough; there were a lot of people who did not fully agree with the change, but nevertheless given the two choices—one between the existing condition and the opportunity to clean house—chose the reform measure.

And now to propose a decrease in capital gains tax with a 3-year waiting period phased in, certainly that is not an inducement. You come from the investment world. That is not an inducement to hold onto a security. It is not an inducement to make an investment in capital goods. What I see is that, having agreed to tax reform, to now suddenly change that with a decrease in capital gains, I think is a little deceptive to the American people, and once again, we are applying a tax decrease to those who can afford most to actually pay more in taxes.

That is it, Mr. Chairman.

Chairman SASSER. Thank you, Senator Lautenberg.

Senator Grassley?

Senator GRASSLEY. Mr. Chairman, first of all, I want to put a statement in the record.

Chairman SASSER. It will be admitted into the record.

[Prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR GRASSLEY

Mr. Chairman, the President's budget outline has two features which I believe are long over-due.

First, overall spending is essentially frozen, relative to last year. Second, it uses what resembles a current law baseline rather than current services.

I remember joining several of my colleagues on this committee five years ago arguing for these.

Given the size of future deficits facing us, we must adopt a freeze in spending for this and future budgets are readily as we have adopted rosy scenarios in the past.

Rosy Scenario has long been a principle culprit militating against long-term deficit reduction, especially spending restraint.

The other principle culprit has been baseless rhetoric that called spending increases spending reductions. The avoidance in the President's budget of using a current services baseline is something I hope this committee will consider adopting for the future.

Finally, Mr. Chairman, I would like to stress a fundamental point about the budget process.

We keep hearing that the President's budget does not provide details.

There are two points we mustn't lose sight of. First, a detailed budget has already been submitted—by the previous administration. And second, the ball is now in our court. Our problem on this committee has always been a curious desire to abdicate our responsibilities and negotiate a budget with the executive branch.

But I would submit that the reason deficit reduction has been hard to come by is because we negotiate. Negotiations with the executive branch have resulted in across-the-board increases, not cuts. All parties end up getting a little bit more, not less.

I would suggest, Mr. Chairman, that we try a new approach this time. This committee should not wait around for a summit agreement.

Instead, we should move quickly, putting together a package with sufficient spending restraint, but also enough fairness to provide the kind of moral authority necessary for a tough budget, and for winning support for a budget independent of the executive branch.

In that regard, Mr. Chairman, I believe the President's budget outline gives us a good framework for trying this new approach. But it'll be up to us to arrange the priorities to reflect the highest degree of fairness.

Thank you, Mr. Chairman.

Senator **Grassley**. I surely believe that the current services baseline needs to go, and the current law baseline is long overdue. So I want to thank you for highlighting that, and I hope you keep on doing it.

I think a freeze on overall spending is long overdue—and of course, you have not done that in your budget. I would go further than you would along that line. For instance, those of us in agriculture would be very thankful to have a freeze. And I imagine, if I can predict from past experiences, probably agriculture is the only program that will be cut when we get done with these negotiations.

But in regard to negotiations, I want to say that I do not think we should be waiting around for a summit—I am speaking to my friends on the Hill here. My experience is that negotiations result in everybody getting a little bit more funding, and how that is always covered up is by even more rosy scenarios than what the chairman has already spoken to.

And you talk about negotiations, and you have got every right to do that—I do not find fault with that—but I think you lend yourself to adding to the problems that Congress has, and that is, we never really want to bite the bullet, we never really want to make the tough decisions that have to be made, and we are always looking for a place to take cover. And I think you are giving us an opportunity to hide behind the bush. And I think that you ought to encourage us to come out from behind that bush, because I know since November, it seems like every time major problems come up for discussion to leaders on the Hill, the response to the press has always been, "What does the White House think about it? What is the White House's proposal?"

And I do not know, but I kind of like the approach that has been pretty successful in this country for the last 200 years, and remind everybody that we have only had an Executive budget for the last 68 years. And you have made your proposal, and we have an opportunity now to agree to it or dispose of it however we want to. And I think we ought to remember that Congress has the power of the pursestrings, and we ought to exercise that power. We ought to be willing to bite the bullet and lead the way, and I think for me as a Republican, that means I do not rubberstamp a Republicans' budget, and as a Democrat, you should not be a stumbling block for a Republican President, either.

That is what I think we ought to do. We have certain deadlines that have to be met, budget deadlines, and for sure, when we get down to September 30, if we have not adopted appropriation bills when they ought to be on the President's desk, then I think the President ought to, even a long time before that, remind Congress and the public that, well, you are getting just a little bit behind up there on the Hill.

So that is the environment I would like to have. But if we are going to negotiate, I will be having my own water as well as everybody else. But in the meantime, I do not want to just sit back and not have anything happen here, and I think maybe we are getting ourselves into that position, where a lot of valuable time is going to be lost.

I think you have made your proposal, and you ought to expect the constitutional process to work—and that is that Congress get down to work and exercise the constitutional powers we have of deciding how much money is going to be spent. And I am not going to be blaming you if we've got a budget deficit, because I know that you cannot spend money that we do not say you can spend, and if we are going to have a budget deficit, it is because we passed a budget that was in too big of a deficit.

Now, to a point I want to make about the defense budget, and a question. I would like to have you give this committee an understanding of why the defense budget was not treated the same as the rest of the discretionary budget.

Mr. DARMAN. Could I just comment on your first set of remarks and then answer that question?

Senator GRASSLEY. Yes.

Mr. DARMAN. I understand your point of view with respect to a way in which we could have proceeded and not proposed to negotiate. I think were we to do that, we would have the political advantage. I think that the President's initial presentation is favorably received, and I think if we were to just say, "Now it is the Congress' turn," that from a political standpoint, we could probably come out ahead if we were doing it that way.

But I think——

Senator GRASSLEY. You are saying Congress doesn't know a good thing when it sees it, then.

Mr. DARMAN. First of all, we have been encouraged by Chairman Sasser and Senator Domenici and others' interest in working constructively. But the reason I wanted to suggest that I think we should do that is I do think that this problem needs to be addressed and that just posturing for who is going to get the political advantage in the process is not really the right way to proceed. That is the spirit in which we want to have these negotiations, and I think that if we really want to get something done, it is at least our judgment that that has a higher probability of actually getting something constructive done. It is a judgment.

On the defense issue, the difference, as I have noted, would only be about $1.4 billion if defense were brought down to common treatment, a nominal freeze on outlays; or, to put it the other way around, if the $136 billion residual category had gone up by inflation, that would be going up by $5 billion. So the amount of money involved is not a large amount of money. But the reason that the defense number is what it is is that an analysis was made within the Executive Branch, by the President, of the views presented to him by his national security adviser, the chairman of the Joint Chiefs, all of the Chiefs—each made a presentation on what different levels of defense expenditure would mean, as they saw it from a national security standpoint.

We also had a serious discussion on a subject I know you are expert on—more so than I—and that is how much might be saved from management savings in defense without adversely affecting national security—and as you know very well, there is a big debate on that issue.

And we are, with our number, at the outer limits of what our defense community believes can be done without adversely affecting national security and adversely affecting the international negotiating environment with respect to the Soviets, with respect to Europeans, whom we want to assume a larger share of defense responsibility, and to some extent with people in the Far East.

So there was a host of considerations. I know it is arguable. I think that the number that is there is what the defense community and the President genuinely believe is the outer limit of what can be done, combining management savings and some program reforms in a way that does not adversely affect national security. But it was a national security determination, I would say.

Senator GRASSLEY. The inflationary increase for defense to me means that we are satisfied with the way DoD is doing its business, making its decisions. And I would suggest that the new Secretary of Defense will have an easier time reforming that system if he has less in real terms than he had last year.

Mr. DARMAN. Could I just point out, though, that from the Defense Department standpoint, as you know well, their 5-year plan was based on 2 percent real growth, and this number relative to that plan is a substantial, if you want to use the local concept, reduction. It is from that standpoint a $30 billion reduction in outlays over 4 years, and a $44 billion reduction in budget authority relative to what they had planned.

Senator GRASSLEY. Does the Administration intend to use the current law baseline for future years?

Mr. DARMAN. For which purposes? We are obliged to use the Gramm-Rudman-Hollings accounting for our reporting at mid-session——

Senator GRASSLEY. No; I mean for the budgets of 1991, 1992 and 1993—do you intend to use current law as opposed to current services?

Mr. DARMAN. Well, current services is in part, in some substantial part, current law. And we will be obliged to do so legally unless the Budget Act is changed.

Chairman SASSER. Thank you, Senator Grassley.

Senator Johnston.

Senator JOHNSTON. Thank you, Mr. Chairman.

Welcome to the committee, Mr. Darman. Mr. Darman, I have been around in budgeting almost as long as Senator Hollings and as long as Senator Domenici, and there gets to be a certain sameness to the little scenario we play out, where we come in at the early part and sort of talk past one another.

I would like to talk plainly, if I may. I think that there are roughly 40 billion phantom dollars in your budget—I know that does not offend you, because it is not the first time you have heard it.

Now, there are only three ways to make that up. One is by estimates, by technical re-estimates, or rose-colored glasses, talking about what is going to happen on interest rates, growth rates, unemployment rates, et cetera. They are, we figure, about $10 billion off on economic estimates; about $17 billion on technical re-estimates; and about $10 billion or so on the magic asterisk, unidentified savings.

Now, I know all the answers; I am not asking that in terms of a question, because I know what your answer is. Your answer is, "Well, we are closer than CBO has been." I do not believe that, and I do not think most serious budgeteers believe it as for this year.

But there are only three ways to make up that $40 billion. One is by estimates. The other is by recalculating the targets, which takes 60 votes. And the third is by taxes.

Now, I happen to be no more enthusiastic about taxes than is the President. But it seems to me, Mr. Darman, that this is the first of 4 years of this Administration; it is not an election year. It is a year when we really ought seriously to do some budgeting and not do this business of like moving back the agricultural payments into last year instead of this year, or saying that we are going to get $2 billion from drilling up in Alaska when everybody knows you cannot do that. We ought to do some serious budgeteering.

There are a number of us who have some real good will to this Administration around here who would be glad to do some serious budgeteering with you, but who are not willing to engage in a charade.

I would just hope when you get around to it that you would do things seriously, and that you would get on with the process soon, because having participated in that last budget summit, I can tell you it is going to take a long time to make these tough decisions, and you are going to have to come back and if not "eat crow", sort of explain what you said before and why it really does not apply to what you really have to do.

Would you like to respond to that?

Mr. **Darman**. Well, I agree with you that we ought to approach it seriously, and I agree we ought to get on with the process soon. I won't bother you by providing the answers you know that I would provide, but let me just summarize.

You mentioned one category at $10 billion—$9.6 billion in our terms—that does not have to be made up in the way that you described. That could be made up, just to pick an example, by adopting Reagan policies for those programs. Another option would be to adopt a nominal freeze for those programs. Another option would be anything you would propose in the way of spending restraint for that category. So——

Senator **Johnston**. Having been in that process before, it is just not going to happen. You can say it is going to happen, but it is not going to happen. When you get into those——

Mr. **Darman**. Well, that is your judgment, and I respect it, sir, but I think that if you are presenting analytic possibilities, that that one ought to be one of the possibilities, because——

Senator **Johnston**. I mean, we can always cut social security—but we are not going to do it, so why even think about it?

Mr. **Darman**. Well, I know we are not proposing to do it. But everyone said it couldn't be done, and it was done, it so happens, in 1983. And I remember when everyone said it could not be done, and I was part of those negotiations, and it turned out it was done. They also said you couldn't raise the taxes, and it turns out that was done.

I am not suggesting that that is where we are headed. I am just saying that we are not always right about what we predict in advance can or cannot be done, will or will not be done.

The other point, just quickly, is on the economics. This is, as I have already said, endlessly arguable, but you say CBO's estimates. I could selectively pick CBO estimates, as you know, for example, on tax yield, and I can make our numbers go up by $12 billion rather than go down. Now——

Senator JOHNSTON. Well, I understand that game, and——

Mr. DARMAN. But I do not think we should treat it as if—when you make an assertion sir, which I respect, of course—but when you say it as if it is a certainty that CBO is correct——

Senator JOHNSTON. I know it is not, but I think they are closer to correct, particularly this year, than is OMB.

Mr. DARMAN. Well, every now and then they should get a chance to be closer to correct. For many years, over the past decade, they have not been closer to correct; for some years, they have been.

Senator JOHNSTON. Well, for what it is worth, my own advice inside the Democratic councils and publicly, is to say that if we don't do serious budgeteering, then let's leave it to the sequestration process. I do not think either side wants that, but rather than engage in a charade, I think it may be necessary to do that. And by "charade", I mean playing "let's pretend" with the budget.

We ought to deal this year—this year—and not put it off until next year, not say let's wait taxes until next year and all that, because it is going to be harder next year than this year.

Mr. DARMAN. We have a proposal on that table, sir. We look forward to any other proposals. We are ready to be serious. We are ready to negotiate. We do not want it to end in sequester. It will if we do not come to agreement, because sequester is the law.

Senator JOHNSTON. Well, you get an "A" for mood, and mood counts for a lot around here, and maybe that is a good start. But I want to see the ability really to deal seriously with the budget, and that is going to take more than good mood.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Johnston.

Senator Boschwitz.

Senator BOSCHWITZ. Mr. Chairman, I would yield to some of my colleagues on this side who have been here longer, if I may.

Chairman SASSER. All right. In order of seniority, that would be Senator Nickles, as I understand it.

Senator NICKLES. Mr. Chairman, thank you; and Senator Boschwitz, thank you.

Mr. Chairman, I would just hope in the future—if I can get the chairman's attention—I would hope in the future that we would handle this committee in the order of appearance, as we have done for the last couple of years. I think, one, it would encourage early attendance of members; I think it can be unfair for a lot of our colleagues who have been here for a long time. So I would just make that comment as an observation.

Mr. Darman, a couple of quick comments. In your budget proposal, you call for increasing outlays by what—1.3 percent, or something like that, in 1990 versus what is anticipated for this year.

So that would be an increase [illegible]—we would actually be spending about $16 billion more than last year.

Mr. **Darman**. It would be $13.8 billion on our estimates.

Senator **Nickles**. And you are estimating that revenues will increase by what, about 80-some billion dollars?

Mr. **Darman**. Right.

Senator **Nickles**. So you would have an actual deficit reduction of about $60 billion.

Mr. **Darman**. No.

Senator **Nickles**. Well, if your revenue——

Mr. **Darman**. Sorry. The deficit reduction is larger than that.

Senator **Nickles**. Well, if your revenues are $80 billion—I see your revenues increasing to $1.065 trillion; is that correct?

Mr. **Darman**. Yes; and the other is $1,156.8 billion; and if you just subtract, the deficit goes down to $91.1 billion if you included asset sales. And that compares with a 1989 forecast deficit of $163 billion and a little. So it goes down by the 63 plus 9; it goes down by $72 billion.

Senator **Nickles**. By about $72 billion. Well, that is what I am looking for. So you are talking about a very significant deficit reduction, primarily because you are able to hold spending growth down to about 1 percent, is that correct, and revenues would be growing at about 9 percent under your estimation?

Mr. **Darman**. Those are not the exact numbers, but the principle is exactly correct, yes.

Senator **Nickles**. Well, it is kind of interesting, I have got three or four different tables, and all the numbers are a little bit different, but they are pretty close. You are talking about revenues growing about 80-some billion dollars, and you are talking about spending growing about $14 billion, so you are talking about deficit reduction of about $70 billion—pretty significant deficit reduction, and I hope it happens.

But it will not happen if that spending line, as Senator Symms and some others have indicated, if spending grows by more than that 1.4 percent.

I have also heard some complaints from the chairman of the committee and Senator Grassley and others that, while defense was being treated unequally, but also look at outlays. Now, maybe I spend more of my time on outlays because that is where the deficit figures come, but I see defense increasing by—actual outlays between 1989 and 1990 of——

Mr. **Darman**. It is less than the overall average. It is about 0.5 percent or $1.4 billion.

Senator **Nickles**. One point four billion dollars—so defense outlays would be increasing by one-half of one percent?

Mr. **Darman**. Right.

Senator **Nickles**. But I am looking at non-defense spending increasing in many areas pretty significantly, and I am not saying it is right or wrong, but you have got a couple billion dollars' increase in NASA—that looks like it is about an 18 percent increase—you have $1 billion for drugs; that is a significant increase, outlays going from about $4.5 billion to $5.5 billion. That is well in excess of 15 percent. You have got medicaid increasing in outlays from $34 billion to $37 billion; a $3 billion in outlays increase for medicaid alone. That is about 8 or 9 percent. But defense spending outlays is growing under your budget by one-half of 1 percent.

The reason I make these points—and it is obvious that you are familiar with the figures—but we have heard a lot of demagoguery about how fast defense is growing under this budget, and I see a lot of items growing fairly significantly, and again, maybe rightfully so, but we have not heard any comments about those. All the comments we have heard are about defense.

I happen to be one who is concerned about not getting over-zealous in our efforts in cutting defense spending. If we can cut it and still provide for our national defense needs and goals and objectives, that is fine; but I think we ought to lay the facts out. Defense outlays are growing very slowly, at least between what is anticipated for 1989 and what it would be in 1990.

Now, the real question I have is can we be successful in having the total outlays grow to $14 billion. Senator Hollings mentioned several categories where spending is increasing. Last year, spending increased $86 billion. So last year we had a very significant rate of growth in spending, about 7 percent.

Do you believe we can be successful in holding down the total growth in spending to 1 or 2 percent for next year?

Mr. DARMAN. Only if we agree.

Senator NICKLES. Well, my concern is you came in——

Mr. DARMAN. We can write it on a piece of paper, which is what we have done, but the Congress legislates.

Senator NICKLES. Well, let me just emphasize my concern. My concern is every year for the last 8 years that I have been in the Senate, the President has submitted a defense figure which Congress has cut, and the President has submitted a non-defense figure which Congress has increased. So you are starting in areas that if Congress takes you up on all these proposals that you have made, increases those, decreases defense spending further, I am concerned what that will do for our national efforts, and my guess is you will end up with outlays that will increase significantly greater than your 1 percent, and the deficit reduction will not be as great as anticipated.

I for one notice that we did have spending growth held between 1986 and 1987 to about 1.5 percent. I would hope we would be successful in attaining that low level of growth again, and then we would have real significant deficit reduction.

Mr. DARMAN. Could I just add a quick point? You are right about defense in our budget growing at less than the average for the budget as a whole. In the chance I have had to respond on this issue, I have not cited all of the figures, partly because Senator Domenici led off by reading a set of highly relevant figures on this exact point.

Finally, with respect to what Congress will or won't do, obviously, you are in a better position to judge than I, but it is my sense that although we have come in with a lower defense number than has been the case in the past, that there is some considerable appreciation among Senators especially that we ought not to continue to have negative growth in defense; that it is my sense that there is a substantial number of Senators on the Democratic side as well as the Republican side who are concerned that we not spend too little on defense.

So I am inclined to think that there is a natural floor on the defense number.

Chairman SASSER. Thank you, Mr. Darman.

Thank you, Senator Nickles.

Senator Simon has been waiting patiently since 10 o'clock this morning, so——

Senator SIMON. Not that patiently, Mr. Chairman.

Senator DOMENICI. Senator, without using your time, would you yield just for an inquiry as to where we are going in terms of the time here, of the chairman?

Senator SIMON. Yes.

Senator DOMENICI. I have never seen as much interest in a hearing as this in perhaps 3 or 4 years. I think we ought to surely give everyone a chance to be heard. But I am thinking, Mr. Chairman, that it is rather unusual that we go through a lunch hour. I assume Mr. Darman has some scheduling problems, and other Senators do. Could we for just a moment discuss what your pleasure is? Are we going to go right on through and finish, or are we going to take a break and have him come back?

Chairman SASSER. Well, Senator Domenici, ordinarily I would suspend for lunch, but given Mr. Darman's schedule and his necessity of meeting with the President before the President leaves for the Far East, I am prepared to just go straight through. And I would anticipate that we ought to be able to conclude this within another hour, perhaps.

Senator DOMENICI. So that if we want to participate here, your notion is we should adjust our schedule to go right on through for another hour or so.

Chairman SASSER. That would be my judgment.

You are still operating under a time constraint as I understand, Mr. Darman.

Mr. DARMAN. Yes; Mr. Chairman. I appreciate your willingness to accommodate it.

Chairman SASSER. Well, in that case, I just suggest we go straight through, and try to be as brief as you can, Mr. Darman, in your answers, while still giving us a clear and pointed answer.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman SASSER. Senator Simon.

Senator SIMON. I would just point out to the timekeeper that dialogue is not on my time here now.

In your statement, you say, "If we wish to see interest rates come down, we should move forward with responsible deficit reduction." I agree completely.

Prior to the President's budget message to Congress the other night, I told some friends if the President tackles the deficit problem, we are going to see interest rates come down; if he ducks, we are going to see interest rates go up.

And while I agree with Bennett Johnston, my colleague from Louisiana, the tone of the message was excellent. I think basically, he ducked, and I think the danger is we are going to do the same thing.

You mentioned the social security compromise. There were no preconditions to that. We sat down—I was not part of it—but it was worked out. I think that is what we have to do here.

Now, let me follow through on what my colleague, Senator Hollings, was talking about. You used the word "Wonderland" in your testimony, and I am afraid that is too apt a description of where we are, because the deficits listed—fiscal year 1987, $155 billion; fiscal year 1988, $150 billion; fiscal year 1989, $170 billion, minus $6 billion for one-time sale of assets, plus maybe $11 billion for savings and loan—let's just say $170 billion. But social security ran a surplus in fiscal year 1987 of $19 billion; in fiscal year 1988 of $39 billion; in fiscal year 1989, apparently about $56 billion. So that the real deficit, not counting any of the other trust funds, is $174 billion for 1987; $189 billion for 1988; $226 billion for fiscal year 1989.

And I think those are the numbers we have to deal with. We have "reduced" in quotes the deficit through a very regressive tax system in having people on social security pay into it. And we are only fooling ourselves on the future.

I hope we avoid that "Wonderland"; I hope we face up to this thing.

I can remember when I was on the House Budget Committee, and Ed Muskie and Henry Bellmon were the two sitting where Jim Sasser and Pete Domenici are now sitting; and we ended up with some very realistic, bipartisan budgets. I hope we can do the same. I think the danger is the very phrase that Fritz Hollings used—"playing games". I hope we do not do it. I hope we really not just dance at the edges of this deficit—and I think that is the danger—I hope we do not dance at the edges of this deficit, but we assault it. That is what the American people really demand of us.

Now, in terms of one of the things you mentioned one time in your statement, but I know the Chairman of the Federal Reserve Board is concerned about, is inflation. Paul Volcker and Arthur Burns both warned us that indexing tax rates is in and of itself inflationary. I frankly don't know that Alan Greenspan has taken a stand on that; maybe he has.

When you say no tax increases, does that exclude the possibility that we discontinue temporarily until we get this deficit under control the indexing of tax rates?

Mr. DARMAN. If we were to change so the tax rates or the brackets were not indexed, that would be a tax increase and would be viewed as such by the President.

Senator SIMON. And are you saying that when you negotiate, you are setting all kinds of preconditions on negotiations?

Mr. DARMAN. Senator Simon—I know you don't want to repeat this, and I certainly don't, either—I spent about 5 hours testifying on what is or is not a tax, and how to interpret "read my lips" and so on, and I suggest we incorporate that by reference. But on the question of how to treat this in negotiations, I have said publicly what I believe is the Administration's position, that we cannot be in a position of setting preconditions about what should or should not be discussed. If we are negotiating in good faith, we have to be prepared to discuss anything that comes up on the merits.

I have also said, however, that we do not believe that the merits require a tax increase, and the President's position on the issue is extremely well-known. But we are not trying to set preconditions for these discussions. We are trying to get into constructive negotiations. And I think it would be very unhelpful for either the Democrats in the Senate or Republicans in the Senate, or the Administration, to start getting into a big debate about what would amount to the shape of the table or what are or aren't things on or off the table.

In my opinion, if you are in a good faith negotiation and someone else raises something, you treat it with respect. That does not mean, though, that you will agree to it. And the same works in both directions.

Senator SIMON. I understand. I just want to make sure that when we have negotiations, it is a no-holds-barred negotiation.

Then, if I may just take one extra minute here—you held up a document there, that thick one, that looks more like the budget we usually get. Is that more like the budget we usually get, or are we going to get something like that?

Mr. DARMAN. Yes; it was provided over the weekend to staff, and I am sure that it will in due course be provided around more widely.

Senator SIMON. And that has a function by function, so we can——

Mr. DARMAN. Yes, it does, all the way down to the account level.

Senator SIMON. OK, because this, frankly, is not very understandable to those of us who are used to dealing with the budget.

Mr. DARMAN. I appreciate that, but I hope you might also take a look at Appendix A and note that, after you add up everything we have provided through Saturday, we are way, way, way ahead of the normal stage of provision of information in this process.

Senator SIMON. I thank you.

Thank you, Mr. Chairman.

Mr. DARMAN. Thank you, Senator.

Chairman SASSER. Thank you, Senator Simon.

Before we proceed to Senator Rudman, I might note for the record that there is a disagreement between Mr. Darman and myself as to whether or not all of the data have been provided that we wish.

We still have the problem of the so-called "black box" or "black hole" programs that we're going to have to develop more information on.

Senator Rudman.

Senator RUDMAN. Thank you, Mr. Chairman.

I will be very brief, because I think most of the questions have been asked.

Mr. Darman, I want to make first a very brief comment.

We can criticize you for not giving us more detail, but I submit to you that every budget that the President has sent up here in the last 8 years has been called "dead on arrival" when it got here. Yours is still quivering, so I guess you are ahead.

It is my understanding that what you intend to do is sit down and negotiate with the appropriate people about what your preferences might be for cuts and freezes within the $136 billion, is that correct?

Mr. DARMAN. Not just the $136 billion, the whole budget.

Senator **Rudman**. Well, you have given us more details on other elements of your budget, other than the $136 billion freeze out. We have your broad views on defense, we have your savings on certain COLAs, we have your economic projections, whether we agree or disagree, but really, the flack you are taking is pretty much on that $136 billion, is it not?

Mr. **Darman**. I do not feel that we are taking much flack, number one, and number two, it would, in my opinion, not be a negotiation to just deal with the $136 billion.

First of all, Senator Domenici has correctly suggested that the mandatory piece ought to be viewed as a whole, and second of all, there are many, many proposals in the budget about which we would like to know what the Congress 'view is.

Senator **Rudman**. Particularly where we might come up with the funds out of that $136 billion to meet some of the upside priorities that the President has set forth, 2 weeks ago Thursday, is that correct?

Mr. **Darman**. Yes, or looking at it the other way around, fail to come up with funds.

Senator **Rudman**. All right. Well, I think that is very clear. I think that is exactly what you have done, that is your strategy. Some people do not like it.

I think it is good strategy, because for all intents and purposes we have saved a lot of people a lot of money. We do not have every special interest group in the country now in our offices; that will at least defer for another 4 to 5 weeks.

That is exactly what happens every time that you come up with all of the pain. You have given us the gain and none of the pain, and when it leaks out of the summit where the pain is going to come, then the hotels will fill up.

The final thing I have to say to you is, I do not have anything else to say to you, because there is a good rule amongst trial lawyers that you never ask a question that you do not know the answer to. There is a further one: Do not ask a question you are not going to get an answer to.

Based on the last 3 hours I yield back my time. [Laughter.]

Chairman **Sasser**. Well, thank you very much, Senator Rudman. Senator Sanford.

Senator **Sanford**. Thank you very much, Mr. Chairman.

Mr. Darman, thank you for being here, and for your patience. I know you do not need my sympathy, but I would comment that I think you have been given an impossible task.

The good news is that what I think I heard was that you realize that this budget exercise is pretty much the way Senator Hollings described it, and when we get past this fiscal year 1990 budget resolution, maybe we can look at ways of improving our system of bookkeeping.

I suppose that what really offends me more than anything else is that we are deceiving ourselves, and deceiving the public, when we contend that we have the Federal budget under control, or the deficit under control.

We went for $108 billion in 1988; but achieved a real deficit that year of $225 billion, considerably more than $108 billion. It will reach more than $200 billion this year, and next year, so we really are practicing a degree of deceit that I do not think is appropriate for this body and for this government.

Let me ask you about the provision that has been carried forward, the recommendation, once again, that has been all of President Reagan's budget proposals and now President Bush's proposals, that is that the President recommends that we have a Constitutional amendment requiring a balanced budget.

Is that correct, or is it in this budget proposal by mistake?

Mr. DARMAN. No, it is correct, and it is in there. In fact, it is one of the first proposals in the book.

Senator SANFORD. Well, I read it that way, but I thought maybe, since nobody has paid any attention to it over the years, that maybe you did not mean it.

Mr. DARMAN. No, it is there and it is a serious proposal.

Senator SANFORD. Let me ask you this: How would you define "deficit" if we had a constitutional amendment? How would we know when we had the budget balanced?

What is a deficit, in other words?

Mr. DARMAN. Yes; I do not have the definitive answer at the moment, but let me tell you conceptually what I think is a problem we are not adequately addressing yet, either by Gramm-Rudman-Hollings, or by just talking about the deficit.

As Senator Hollings has suggested, and others have noted, the way we do the accounting now, especially for the trust funds, does not take into account sufficiently the future obligation to pay those trust funds for the paper they are now getting.

A way to get at that is to look at total debt, as a percent of gross national product, not just as we routinely report, publicly funded debt, as a percent of gross national product.

If we would—but this starts to get technical, and a lot of people do not really understand what we are talking about, and I am not sure that we could organize a process that would focus on that. But analytically——

Senator SANFORD. Well, I understand exactly what you are talking about. You are saying, I think, that the increase in the gross national debt is really the deficit.

Mr. DARMAN. The total debt. That is the way it should be viewed.

Senator SANFORD. But it is not.

Mr. DARMAN. But it has to then also be viewed in relation to another thing, which is, what is the investment in future productive capacity?

Because if you just have an arbitrary amount of GNP that you say "total debt," publicly traded and the stuff that is just written on the books, but that someday does have to be funded—if you say you are going to limit that as a percent of GNP, you still do not know if you are doing anything sound when you are spending current money until you look at, is the current money being spent in a way that not only takes care of immediate obligations of certain kinds, but also is investing in future productive capacity to service that debt?

Senator SANFORD. Well, granted, you can analyze it any way you want to, but what you are saying, if we had a constitutional amendment, it would be measured against the increase in the national debt.

Mr. **Darman**. Well, I am not actually proposing that at the moment, but I am just saying that analytically——

Senator **Sanford**. But is there any better definition of deficit?

Mr. **Darman**. Analytically, that is the direction in which to head, is what I am saying. But the problem, just again, is, you would pick a different level of acceptable debt defined that way, depending upon what you thought the society were doing in the way of investment.

Senator **Sanford**. No question about it. But if we had a Constitutional amendment we might not have that choice.

Mr. **Darman**. That is true.

Senator **Sanford**. That raises yet another question, but the point I wanted to make, that our real problem is debt. We have been arranging the furniture on the deck, and the hole is filling up with water, but we are not really giving any attention to it. We are covering our eyes and not admitting it.

Just glancing at the historical tables, the budget deficit, as I would define it, went up $255 billion in 1988; is projected to be $268 billion in 1989; projected, probably a little low, but nonetheless frightening, to be $239 billion in this 1990 budget. So we are not really getting at the problem.

I think Gramm-Rudman-Hollings served a very good purpose, initially. It certainly showed us that Congress could discipline itself, but we have not been getting at the real problem. I hope we can get at our real problem when we get this budget resolution exercise behind us. Unfortunatley it probably will not be any better than our other budgets.

It is going to leave that debt mounting, and with all the dangers that it brings, with foreign investments, its relation to trade deficits, and do I understand you, that you are ready to talk about that when we get this budget behind us?

Mr. **Darman**. Not only that, I would like to include it in the negotiations as part of the negotiations, but I do not think we should start there, because I think that if we do, we will find ourselves defining our way out of the problem, instead of defining the problem in a way that forces us to focus on it.

Senator **Sanford**. Well, I agree, we ought not get too involved here with the budget process itself, but I would feel much better if I thought you were seriously ready to look at it.

Mr. **Darman**. We are very serious. Very serious about that.

Senator **Sanford**. Good.

Chairman **Sasser**. Thank you, Senator Sanford.

Senator Gramm.

Senator **Gramm**. Well, Mr. Chairman.

I would like to say to my dear friend, Fritz Hollings, that you can agree with him, but you never have to doubt where he stands on the issue. Fritz wants to raise taxes, and I want to control spending, and I think that is what this debate is about.

In essence, as I listen to——

Senator **Hollings**. I want to control spending by raising taxes.

Senator **Gramm**. Well——

Senator **Hollings**. If you don't restate——

Senator **Gramm**. Wait a minute, now, Fritz. I listened to you for 15 minutes. Listen to me for five. [Laughter.]

Senator **Hollings**. I want to control the interest spending by raising taxes.

Senator **Gramm**. In essence, as I listen to our distinguished colleague from South Carolina, he looks at this budget and says that a growth in spending of less than 2 percent is not enough, and therefore we ought to raise taxes so it can grow faster.

Senator **Hollings**. I said freeze. If you keep misquoting me I am going to sit here and I am going to take exception. I said freeze, and I made that quite clear.

Chairman **Sasser**. Senators, please address your remarks to the Chair.

Proceed, Senator Gramm.

Senator **Gramm**. Well, if I might, then, let me just ask you a question, Mr. Darman.

If we froze spending in the aggregate at last year's level, would we meet the Gramm-Rudman-Hollings targets?

Mr. **Darman**. Yes.

Senator **Gramm**. We would be below those targets by some $15 billion.

Mr. **Darman**. Correct.

Senator **Gramm**. So that when you are talking about raising taxes, and unless you are going to set some new, lower targets, you are talking about letting spending grow faster than that $15 billion, is that not right?

Mr. **Darman**. Well, I do not want to create a problem, but I would defer to Senator Hollings on this.

Senator **Gramm**. Let me, as long as I have the floor, make another point. You were asked by Senator Grassley about defense, and I think it is important to note that—my guess is, though I had not checked the last two Carter budgets—that this is probably the first budget in 10 years that increases non-defense outlays by a larger percentage than it increases defense outlays.

In fact, by my rough and ready calculations, non-defense outlays, and this is excluding interest on the debt, grow 5.68 times more than those for defense outlays.

So would you say that one criticism that cannot be leveled against this budget, that was often leveled against the Reagan budgets, is that this budget is not proposing to cut domestic spending to fund defense?

Mr. **Darman**. That is correct.

Senator **Gramm**. Let me finally ask you the following questions about the CBO baseline—let me add that I agree with you, I see nothing sacred about CBO. I think we ought to be suspicious of both CBO and OMB estimates.

The problem is, however, it is not what you assume that is important, it is what you do about it.

But if you took the CBO's entire estimate package, the richer yield in revenue, the different assumptions concerning spendout, except for savings and loans, which we now have a program on the table for—we did not have that when they made their estimate—how much different would the budget deficit estimates be?

Mr. **Darman**. I do not have the answer immediately, but you are right, that a very large portion of the difference in the technical side on the assumptions is the S&L difference, which should have been overtaken now by the proposal.

If we took this CBO income share distribution and associate a tax yield, I think that would actually improve our figures by $10 billion or $12 billion—I am going from memory. It depends on how many of the CBO assumptions you would want us to take.

We could certainly take a reasonable set and have the two come out relatively close.

Senator **Gramm**. Well, the point I would make is, CBO has more revenues that you do. They have got 86 and you have got 82.

Mr. **Darman**. We could have even more, though. It depends how selective you want to be, and which elements you want to take.

Senator **Gramm**. But I guess the point I would like to make is, is that even not being selective at all, if you go back and plug in the savings and loan package that is actually on the table now, into the CBO estimate, that that eliminates a substantial part of the difference, and that the plain truth is that CBO and OMB are not very different, in terms of what the reality is out there, when you knock out the roughly $5 billion difference on savings and loans, given the package we actually have.

So the big debate here is not what we are going to assume, the truth is that both CBO and OMB show roughly the same size hole. The question is, what are we going to do about it?

Mr. **Darman**. I would agree with you, for purposes of keeping this moving. You are certainly right, that they could be close, and the S&L thing is probably about $6 billion to $7 billion worth of the difference, in terms of the technicals.

Senator **Gramm**. Now, finally, let me go back to the million dollar question here, because I was a little bit confused. I understand negotiating, and this idea that we want all viewpoints discussed, but let me see if I have the correct understanding.

Do you think there is any possibility that at the end of these negotiations that President Bush is going to accept a tax increase?

Mr. **Darman**. I think that his answer would be, "No."

Chairman **Sasser**. Thank you, Senator Gramm.

Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

We have had Federal Reserve Chairman Greenspan before the Banking Committee today on monetary targets, and much of the discussion of course, relates to budget assumptions and growth targets, and things of that kind.

Let me welcome you, Mr. Darman. I know this is a difficult assignment that you take on at OMB, and I want to wish you well with it.

I want to get right to an issue that has probably been raised earlier in the morning—on the fact that we are borrowing and spending the Social Security Trust Fund to make the deficit look smaller than it really is.

I think this is an inherently dishonest action that the government is involved in, and I think it is one that has real risks for the future. I want to just take a minute to explain what I think is going on, and then I am going to pose a question to you.

This year, in trying to meet the Gramm-Rudman-Hollings target, we are going to borrow $68 billion from the Social Security Trust

Fund, and we are going to leave IOUs in the Social Security Trust Fund. We are going to take this $68 billion and bring it over and spend it on the day to day operations of government.

Some will be spent for defense, some of it for the drug war, some of it for education, farm programs, what have you. And by bringing over that $68 billion out of the Social Security Trust Fund and spending it on the day to day operations of government, we make the deficit look smaller by that amount.

Now, it is not really smaller, because, in fact, we should not be spending the money that way, and we are leaving IOUs over there in the trust fund.

And it seems to me that we are heading, with that kind of accounting trick, to a point where the people who are putting their money in social security today, like you and I and other people in this room will realize that this money is not being set aside in the Social Security Trust Funds as it should.

It is supposed to be there to pay future retirement benefits, but the money is being taken out, brought over into the general area of government, being spent each day, and in the future we are going to have to put all of that money in a second time.

The taxpayers are going to have to come up with the money to pay social security back for all the money that has been borrowed and spent, so we are going to get to pay for our social security twice. We pay for it now, and in the future, when all these IOUs have to be paid up, we are going to have a chance to pay a second time.

When the public finds out what is going on—that we are actually, in effect, looting the social security reserves in order to pay for the day to day operations of government, and we are really doing it to make it seem as if we are meeting a certain deficit target when we are not, in fact, meeting it—I think they are going to be very angry. Very angry. And I think they are going to have a right to be.

And I think if we go along with it, we are being very irresponsible. That money is, in fact, being used up, and not being set aside for the purpose that it is supposed to be there for.

Now, my question to you is this—and I know you are new to this job, and that you did not start this process—but how do we justify taking those Social Security Trust Funds and spending them each day in the general category of government, and treating that as if this is actually reducing the deficit?

How do we justify that? And why should we not stop that practice?

Mr. **Darman**. Well, Senator, you have referred to it as an "accounting trick."

Senator **Riegle**. I think it is an accounting trick.

Mr. **Darman**. Let me say first that I agree with most of what you have said, but just on the semantics, I do not view it as an accounting trick, for this reason:

Number one, the consolidated budget should include the way social security is treated now, insofar as the purpose of the calculation of the consolidated budget is to determine how much debt has to be funded publicly. That is an important number to know, it is an important number to manage too.

So, from that standpoint, it is thoroughly appropriate to treat it the way it is treated.

Second, the fact of the trust fund buildup, and its interrelationship with the consolidated budget is not only well known to the Congress, and has been ever since the projections were put forward in 1982–1983, it is well known to those who wrote Gramm-Rudman-Hollings, it is built into the target, the calculation of the targets, it was discussed in the process, it is well known to all analysts.

It is not some mystery. The accounting trick is not really fooling any of the sophisticated participants or the analysts.

Furthermore, it is not——

Senator RIEGLE. How about the general public? Do you think they understand it?

Mr. DARMAN. Well, I do not believe that the general public has much of a view of either set of numbers, but you would be a better judge than I about what the general public does or does not think on the subject.

Finally, it is not a trick in this sense, in that it is a full faith and obligation of the government. It is not as if there is not such an obligation there. The paper they hold does have to be funded.

In that sense, it is not phony, but it is the case that it is not yet, in a sense, fully funded.

And I think that, for purposes of managing Treasury funding, we still need to have a consolidated budgeting system that includes what the flows in from the social security area.

For purposes of dealing with our long-term interest in having both the debt funded by the public, and other hidden IOUs in the system, have them limited, as a percent of GNP, yes, we need to change the accounting, and I have said so.

I have said, however, that I do not think we should do it before we get about the business of reaching a deficit reduction agreement, because most of the proposals I have seen for doing it—in fact, I believe they have to involve changes in Gramm-Rudman.

And as soon as you open up that, if that is what we start this budget process by doing, we are going to avoid the substantive debate and get into nothing but an accounting debate, and that, I think, is not what the system calls for at this stage.

Senator RIEGLE. Well, it is not, to me, an accounting debate, it is the question of what is the real operating deficit, and is the real operating deficit a lower figure because we are borrowing and hiding part of it with the Social Security Trust Fund, or is it higher?

Mr. DARMAN. May I ask you a related question?

Would your definition of the real operating deficit take—in other words, adding the social security surplus to the existing deficit, which is the way you would define it, right? Would you say that, if that is the deficit, we should still have a Gramm-Rudman-Hollings target of 100? Or would you adjust the Gramm-Rudman-Hollings target?

Senator RIEGLE. I think the Gramm-Rudman-Hollings target that we have now is really a sort of a fictitious number, because it does not really measure the day to day operating deficit of the government. In effect, we have gotten caught in a box here.

We have not been able to squeeze down the real budget deficit. The only thing that has allowed everybody to take a finesse on it, is that we are tapping the buildup in the trust funds, and applying in this larger accounting sense——

Mr. **Darman**. I guess all I——

Senator **Riegle**. Let me just finish.

Mr. **Darman**. I am sorry.

Senator **Riegle**. The standard definition, obviously, is to say that we are looking at all of the debt obligations of the government.

But the real question here is, what is the operating deficit of the government? And the problem is that you folks, and we, want to spend more money this year on the day in and day out operations of the government than you want to raise in revenue. By a lot. By a lot more than just what we say with the numbers.

You want to continue to pile up huge deficits. And there may be a difference of opinion as to whether you spend all of the money on this, or you spend all the money on that, but you are coming along with exactly the same formula that we have seen for the last several years.

I know you do not think you are, but if you take away your ability to go over and grab that money in the Social Security Trust Funds, and you have to face the fact that the spending plan you have proposed must be financed some other way, you are left with a $68 billion gap, and you have got no way to fill it.

Mr. **Darman**. Neither does the Congress, Sir.

Senator **Riegle**. I am not saying that we do, either.

Mr. **Darman**. It will not happen, and so I would like to work on things that have a chance of happening. That will not happen. What can happen is——

Senator **Riegle**. Well, that is what is happening. I mean, we are going through the accounting fiction, to hide the reality.

Mr. **Darman**. If you believe all of the numbers associated with the social security surplus projection, then you should also believe that you do not start to have to deal with the fact that the surplus is disappearing until 2018.

Let me just, if I might, finish this point. Sometime, a lot sooner than 2018, we need to start working on that problem. What I have suggested, and I have—I am not approaching this in the standard way.

I did for several hours, in the process of being reviewed for confirmation, agree that we need to change the accounting. I am with you on that.

I have also said, however, that we should not break the existing system with a view toward dealing with a problem that is several years away until we have at least addressed the problem within the current framework.

If we make the existing problem immediately $68 billion worse, look at how much trouble we are having just dealing with this little difference between us. If we add that, this system is not going to produce, and that is going to make the economic performance much worse, and we will have accomplished nothing.

So what I say is simply, let us reach agreement within the existing framework, then let us have the discussion, where I would start out agreeing with you, we ought to change the accounting and change the framework.

But let us not reverse the order. If we start by defining the problem as $70 billion worse, I would be extremely surprised if any of us could reach a conclusion other than change the target, which would be the worst possible signal to financial markets.

Senator RIEGLE. Well, let me tell you something—and I am going to finish with this, because my time is up—you talked about the sophisticated observers earlier, in terms of how they view this whole puzzle. I am interested at the moment in how the American public looks at it, because they are really the ones whose fate is on the line here.

I think when they find out that in fact we are taking the money out of the Social Security Trust Fund, we are spending it for another purpose, totally unrelated to social security, we are putting a lot of IOUs in there, which in the future they are going to have to pay for, in effect a second time, I think they are going to be furious about it. And to say that by the time we get out into 2017, and somebody else will have to come up with that money, is not going to satisfy the public.

Of course, you will be gone, we will all be gone, everybody will be gone. But we want to consume a lot more than we want to produce, and we want to spend and have in the way of government activity, a lot more than we want to pay for.

And we are maintaining that very fiction today. I just say to you, as somebody who wants to see you succeed in this job, that for the administration to start off on the foot of marrying itself to the fiction that the deficits are really lower than they in fact are, while hiding behind all these IOUs, the money we are taking out of social security is going to come back to haunt this administration, back to haunt you and all of us who are a party to it.

Chairman SASSER. Thank you, Senator Riegle.

Senator Boschwitz.

Senator BOSCHWITZ. Well, Mr. Chairman, in 2017, I will only be in my seventh term, I was just figuring out, and considering the longevity in my family, I will still have one or two to go.

It is not clear to me, as I listen to my friends and colleagues from the other side talk about budgets being "dead on arrival," "black boxes," and "black holes," and then laying it on the President when things do not work out.

I must say to my friend from Michigan, I would be agreeable to adjusting the Gramm-Rudman targets and stretching them out by at least a year, but it is not clear to me what the Senator would do with the surpluses that are developing in the Social Security Fund.

We certainly are not looting them or grabbing them, and the fate of the American public is not on the line if we invest them in government securities.

I might ask Mr. Darman, if we don't invest them in public security, and if that interest is not compounded between now and 2018, I suppose that the fund will start going down far sooner than 2018, that built into the $12 trillion that is eventually going to be in the fund is a lot of interest.

Maybe the Senator from Michigan wants to just put it in an account somewhere where it does not draw interest. Maybe he wants to put it in some savings and loan. Maybe he wants to put it in high yield so-called "junk bonds," which if they get paid, would really build up. It has to be put, both by law and by common sense, into government securities.

Because government securities are rolled over or paid back, that money has to be borrowed from somewhere. Certainly it should be borrowed from another government fund. Have you made any calculations, Mr. Darman, as to what would happen to the Social Security Trust Fund if it were not drawing interest?

Mr. DARMAN. No, but it is very easy to do, because the projections that everybody has are divided, normally, in two long columns. One of them is principal, and the other is interest, and I just do not have it in front of me, or I may, but it would take a few minutes to shuffle through and find it, but——

Senator BOSCHWITZ. Well, I think we would——

Mr. DARMAN. But I would make a different point, and that is, I have not heard anybody suggest that if you had the Social Security Trust Fund investment it ought not to be invested in anything. In other words, I am not sure what form it would be held in, but that it would have no interest.

The issue tends to be as you were just suggesting. If you are not going to invest in governments, what are you going to invest in? Are you going to invest in junk bonds, or is it going to become a venture fund?

There is a point at which, by the way, you could buy a good portion of the economy, and we would end up with an odd situation. It might look a little bit like a socialized economy, where you could have this, if you didn't invest in the governments with a couple of trillion dollar surplus, there is quite a bit of corporate America you could own for a couple of trillion dollars.

Senator BOSCHWITZ. Oh, yes; it is not clear to me what the Senator from Michigan wants. Maybe we should invest in Japanese bonds. Maybe he feels in that case that Japanese bonds——

Senator RIEGLE. If the Senator wants to yield for a reply——

Senator BOSCHWITZ. Well, not on my time.

Senator RIEGLE. I did not think that he wanted to, but there is an answer to that question.

Senator BOSCHWITZ. Well, there will be another round, and I certainly suggest you address it at that time.

I think we would be looting the fund, grabbing or fooling the general public if we did not invest it in government bonds, and if we did not allow that interest to grow and make the fund healthier and stronger.

I have a specific question, but I would like to talk for just a moment about the budget. The spending, as a percentage of gross national product, has come down quite nicely in the last 6 years.

Six years ago it was at close to 24.5 percent of the GNP, and now, this year, it is projected to be 21.7 percent of the GNP. The trouble, of course, is that taxing is less. I don't consider that a trouble from the standpoint of wanting to raise taxes, but 6 years ago we were taxing 19.5 percent of GNP; now, I think it is 19.7 percent of GNP. So a deficit remains.

Taxes have held pretty steady—they have not gone down—as a percentage of the gross national product. I have always approached the budget by saying that we are not taxing too little, but rather that we are spending too much. If we could slow down the growth of spending to 1.5 percent to 1.4 percent, we indeed would be making great strides.

It is interesting to note, as Senator Nickles pointed out, that in 1987, spending rose by about 1.4 percent over the preceding year, and that revenues rose by 10 percent, and the deficit went from $221 billion to $149 billion, fully one-third in 1 year.

And if we can moderate the growth, in one way or another, and if we in the Congress have the nerve and the resolution to moderate growth, I think that we will be able to quite quickly bring the budget into balance. We've already made progress by doing that.

As a percentage of the gross national product, the budget deficit has come down by about a third in the last few years. As a percentage of the gross national product—and I don't mean to make excuses for the deficit—but as a percentage of the gross national product, our deficit is less than almost any other industrial nation—I think the Brits now have something of a surplus—and its growth rate has been less than virtually any other industrial nation.

So I think that we have been showing some discipline, and as a matter of fact, in the last few years, growth rates have been less in spending than at any time in the 10 years that I have been on this committee.

In 1988, we let things get out of hand a little bit—an election year is too great a temptation, I suppose.

I might say, also, to Mr. Darman, that I am introducing a bill this week that will require the President to submit a budget based on last year's spending, and not on so-called current services.

My good friend from Michigan, again, in talking about social security, talked about fooling the general public. Well, I tell you that when I try to describe how we do the budgeting down here, and say that increases must be figured from an automatic increase over the year before, and that increases or decreases are computed on that basis, they think that is kind of funny.

That is certainly not the way they compute their own budget, and I think that the way we are doing it here is in the realm of fooling the general public.

So I will be introducing that. I have a number of cosponsors and will get some more, I am sure, in the course of the week.

Chairman SASSER. Senator Boschwitz, your time has expired, Sir.

Senator BOSCHWITZ. May I ask one specific question?

Chairman SASSER. Well, would you get to it quickly? We are running out of time, and you have run over time now.

Senator BOSCHWITZ. I will do so.

Have you looked at the Small Business Administration? I have risen, around there, to be Senior Republican on the Small Business Committee, and if my colleague from New Mexico would control himself——

Senator DOMENICI. I am swooning.

Senator BOSCHWITZ. He is swooning. And the loan guarantee program over there is running out of money, although there are some surpluses in other programs.

The Loan Guarantee Authority for Section 504 construction loans and Small Business Investment Company Programs has a good deal that can still be utilized, and I wonder if you have given any consideration to the possibility of switching that guaranteed loan authority to the regular Small Business Administration loans that are now oversubscribed?

Mr. **Darman**. Senator, I am sorry to have such a short answer, but I have not considered that specifically. I would be more than happy to do so.

Senator **Boschwitz**. I look forward to negotiating with you on this budget, Sir.

Chairman **Sasser**. Thank you, Senator Boschwitz.

Senator Domenici, I do not know if we are saving any time by just you and I having opening statements or not. We seem to get around to them anyway.

Senator Wirth.

Senator **Wirth**. Thank you, Mr. Chairman. I will yield briefly to Senator Riegle.

Senator **Riegle**. I thank Senator Wirth.

I just want to add one item here to my friend from Minnesota, and that is, you would invest the social security buildup in hard assets in a variety of different forms.

You could use the money to modernize America, help the private sector raise the money that it needs for new factories, new technologies, new techniques. There are a variety of ways of managing a trust fund and investing in assets.

Senator **Boschwitz**. Sir——

Senator **Riegle**. I do not yield to the Senator; he chose not to yield earlier, and I do not want to take any more of Senator Wirth's time. The fact of the matter is, the money today is not being invested in hard, income-producing assets.

By and large it is being spent today. It is being consumed. It is improper that that is being done. There is a way to invest that money in a way where the capital is protected as well as the income-producing aspect.

And that is what we need to do. We need to move to a strategy that accomplishes that, and the Senator from Minnesota, successful as he was in business before coming to the Senate, is wise enough to know that.

I thank the Senator for yielding.

Senator **Wirth**. Thank you.

Mr. Darman, we are pleased to have you here. I wanted to touch briefly on the environmental issue raised earlier, and then talk at a little greater length about education.

I think George Bush has been a welcome change from the last 8 years, as we have talked about that in the past, and as it relates to the environment. But I was a little concerned, as I look at the budget numbers for important environmental programs.

It seems to me that, as you know that as we look at ocean pollution, wetlands, global warming, hazardous waste cleanup—all of those are not cost-less items, and yet, within the Bush budget, the overall pollution abatement and control part of the budget is down 8 percent.

Is that just the budget stringency, or are you telling us that the environmental budget is not the priority that Mr. Bush laid out?

Or, there may be a third. To use your analysis, there are lots of options in this budget area. Maybe there are other non-budgetary ways in which the Administration hopes to reach environmental goals.

I know you all are thinking about various market mechanisms, such as with regards to the Clean Air Act, which I applaud, so this is just an open-ended question to ask you where the priorities are, and what you see the Administration doing?

Mr. DARMAN. I think that—let me just double check to make sure I am right with Bob Grady of OMB, who works on environmental matters, but I think that if you have a figure of pollution abatement down 8 percent it must be based on our table on applying the nominal freeze, because I don't think that——

[Mr. Darman conferring with Mr. Grady.]

Senator WIRTH. Maybe you would like to just supply that for the record.

Mr. DARMAN. No; we will not be able to, because I do not think that the answer will be any better then.

The problem is that that account is in the pot, the so-called pot, or what the Senator refers to in a less favorable way. It's to be negotiated.

Senator WIRTH. This is part of the "black box"?

Mr. DARMAN. It is, and if you look at it——

Senator WIRTH. I mean, cutting it is a possibility?

Mr. DARMAN. Cutting it is a possibility. What we have done is we have said, within the——

Senator WIRTH. That is all I wanted to establish. Why don't we—go ahead. Do you want to just quickly summarize on that front, or tell me if there are some other mechanisms, like in the clean air area, where you may be looking at other possibilities.

Mr. DARMAN. That is true.

Senator WIRTH. I mean, we have established the fact that there may be cuts, and that that would not be something that you all would say is off the table in the environmental area, isn't that right? We have established that so far.

Mr. DARMAN. Both parts are right, yes.

Senator WIRTH. And then looking at other mechanisms——

Mr. DARMAN. That is also correct. We are looking at other mechanisms, we do not yet have agreement among ourselves on a specific proposal, but we are looking at some of the types you have referred to.

Senator WIRTH. Well, as you know, Senator Heinz and I put together what has been called Project '88, which develops, it seems to me, a lot of other ways that we might think about these very, very expensive propositions, and I would hope that you would look at it.

There are ways in which we can operate a little more smartly without having just to pour dollars into the problem, and the Clean Air Act and what we might do about that is a very good example.

Or we could focus on it in a very different kind of a way. The old so-called "bubble theory," now market incentives, and I would hope that you might encourage that, as that might take some of the heat off you for what appears to be some not insignificant cuts.

Mr. **Darman**. Our entering preference is in that direction, applying the bubble theory and using more incentives in the system, some of which would operate more on the private side and not involve direct public expenditures.

But we do not have the formula fully worked out yet.

Senator **Wirth**. I see. Let me ask you about another one of President Bush's priorities, which is education. If you look very carefully at Function 500, and look at the CBO baseline for fiscal year 1990, and look at President Bush's request in Function 500, which, admittedly, has some social services in it, there is a $1.5 billion decline.

So you could say, well maybe that is not education, maybe that is all in social services, so if we go back to the Department of Education's budget authority, we see also there—which drives, the outlays which are a year ahead on that front—we also see a decline, as I understand it, of at least $100 million.

Now, in the education area, if we look at the priorities that the President has laid out, of Headstart, teacher training, student access—I understand that these are among his priorities—none of those, I do not believe, can be done without spending money.

So the question is, are those in the black box as well, or is education exempt from cuts, under the President's direction?

Mr. **Darman**. Well, I do not have the same numbers as you do. In the education area, let me just go from memory here rather than pouring through these details, unless you want them, but I believe that what we have done in education programs amounts to an outlay increase in the order of seven hundred and some odd million dollars, 1990 versus 1989, not a decrease.

That is also true for the Department of Education, an increase, not a decrease. So I do not know where you got the decrease number from.

It is also an increase over the Reagan budget. The amount of the increase is smaller, it is on the order of a hundred and some odd million dollars, but it is also an increase over the Reagan budget. I do not know where your——

Senator **Wirth**. Well, I would hope that there would be an increase over Reagan. In fiscal year 1990, the CBO baseline is $38 billion, the Bush request is $36.5 billion, and that is——

Mr. **Darman**. Well, we do not view a number in relation to the CBO baseline. If you want to look at it in relation to this——

Senator **Wirth**. Well, if you follow that convention, then, if we look at the amount of funding appropriated in the Department of Education as $17.3 billion—just extrapolate from there for inflation to the demographic changes you get to $18 billion, and your request is $17.9 billion.

Well, certainly, I think we can all agree. We are certainly not seeing any kind of a startling change in education funding.

Now, if this is the high priority that the President says he wants it to be, and he wants to be the education President, then it seems to me that we ought to be seeing some evidence of that, and if we are here debating $100 million here, or $100 million there, on an overall budget of the magnitude that we are talking about, it does not seem to me that that priority jumps out, and I was hoping that it would.

I think that his rhetoric was terrific, and I will hope that we might be able to find some assurance that, in fact, there is going to be support for education, which I do not see moving above what we saw from Ronald Reagan.

Mr. **Darman**. Well, in fact, the number is higher, and we can work on that afterwards. The number is higher than 1989, it is higher than Reagan, and it is higher under both the nominal freeze and the alternative one that we provided.

But, in any case, I would grant your point, that it is not dramatically higher, and there we would have a disagreement, I suspect, if we thought that the education investment ought to be viewed in terms of dollars.

There is a philosophical difference, perhaps. Ours tends to emphasize much more a Federal role oriented towards encouraging research, experimentation, innovation, identification of successful approaches, and then, to some extent, an effort to generalize them through the system, but not fund them at the Federal level.

Senator **Wirth**. Mr. Darman, I think you will remember, that time that you and I were both at the Department of Health, Education and Welfare years ago, and we were both there during the early years of Headstart, which at that time was a research program, and then a demonstration program, and has now proven to be probably the most effective education program that we have launched in the country, or certainly among those, and I do not think there is any debate about the evidence.

And yet, one child in about 11, I think, who is eligible for Headstart is involved, and that is predominantly a Federally funded program.

If we are going to be serious about bringing people into the mainstream of American life, and we know that there is a program that works, and it is Headstart, I do not understand how we can make the argument that we are going to have an education President but he is not going to fund Headstart enough to meet current needs. It is being consistent, I think.

Mr. **Darman**. Well, that is not accurate, if I may say, Senator. You are correct about our common view of Headstart, but we increased Headstart by $250 million. That is not a small amount of money. It is true that it does not get to the whole population, but it is a significant increase, in Headstart.

Senator **Wirth**. Well, Mr. Darman, I——

Mr. **Darman**. And as for our common experience at HEW, which I recall as well as you do, you will recall the emphasis back then on the need to fund experimental schools and more innovation and so on, which I think was sound. At that time it was a neo-liberal as well as a neo-conservative idea, and I would like to see us come back together on that emphasis.

Senator **Wirth**. Well, just to come back to my original point. If we are going to put in the freeze Title I, if you put handicapped programs in there too, you put vocational adult education in there as well—all programs that I think have probably been successful—not as successful as Headstart—but you place them into the black box and then that part of the budget goes down, then these important programs go down, too.

The point that I am making, Mr. Darman, is not to quibble about a little bit here and a little bit there, but simply to say to you that I find it difficult to see in this budget a resounding commitment to the goals that Mr. Bush so ably stated in the campaign, and since the inauguration, and I agree with those goals, and I hope that we might be able to find ourselves a better way of meeting those, and I think you are committed to those and so am I.

I just do not see how you can get from here to there with the resources that are available, much as one might be liberal, neo-conservative or whatever.

Chairman SASSER. Thank you very much, Senator Wirth.

We now turn to a valued and energetic member of this Committee, Senator Conrad, who has been sitting here now patiently for 3 hours and 8 minutes. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

You know, when I came to the United States Senate, I was 100th in seniority, and now after 2 years, I have moved up sharply to 89th, and I barely feel it at all this morning.

Chairman SASSER. Well, it reaches a critical mass. You accelerate rapidly after a certain point. [Laughter.]

Senator CONRAD. Thank you, Mr. Chairman. I have been patient, and I have waited because I felt the need to say something about what I see taking place.

I really believe sincerely, Mr. Darman, that we are all engaged in an enormous sham. What we are talking about here today is really fraudulent. If you have a sense of irony at all, it is really amusing to listen to the rhetoric: "We are reducing the deficits," "Deficits are growing," "It is really time to start doing something." It is all talk. It is all rhetoric. It means nothing in the real world.

I heard Senator Gramm staking out the ground that he is against spending, and that Senator Hollings is for revenue. And that certainly is a line of demarcation. And he buttressed the point by saying that with the growth in the revenue we could meet the Gramm-Rudman targets.

Of course, he missed Senator Hollings' point completely. Senator Hollings' point was that the targets are no good. And, clearly, they are not any good. The evidence is clear. In 1988, if you look at the operating deficit, which I include the deficit that we describe to the public, plus the trust funds that we have raided—and that is exactly what we have done. People have said here this morning, "We are not raiding the trust funds" Sure we are; the money is gone. The total operating deficit in 1988 was $253 billion, including the trust funds. In 1989, it will be $297 billion. In 1990, with the proposal before us, according to CBO's numbers, it will be $264 billion. And this, after we went through the great sham of the budget summit 2 years ago in which all the leaders go in a tent and they come out and tell the American people we are reducing the deficit $70 billion over the next 2 years. It has not reduced. It has gone up.

You know, in the last 8 years, we have tripled the debt. And Senator Boschwitz looks at one part of the puzzle and says we are doing better in percentage of GNP.

Senator BOSCHWITZ. That is not right.

Senator CONRAD. I would just note that as a percentage of GNP, the national debt has grown for the first time in 40 years. In the last 8 years the national debt as a percentage of GNP has grown and grown dramatically. We have increased the trade deficit fivefold, gone from being the biggest creditor nation in the world to the biggest debtor nation. And now, as I read the budget document put in front of us, it is just more of the same.

We are going to raid the trust funds. We are going to pay over $100 billion a year in defense bills for Japan and Europe, even though we have to borrow the money from them to do it. We are going to build the debt.

My question to you is: Can't we do better than this?

Mr. DARMAN. Well, we might be able to do a little bit better. I do not think we will do dramatically better, but I would not agree with your characterization.

I agree with some of what you have said, but take, for example, your statement about national debt. It is the case that national debt did rise in the early 1980's and has stabilized and has started to head down in the late 1980's as a percent of GNP, but it is still higher than at the start.

On the other hand, if you look over the rather successful history of this country, the national debt has wandered from way, way, way below where we are now as a percent of GNP to over 100 percent of GNP. We are around 44 percent, I think, at the moment. Our country has gone on and serviced that debt.

The real issue, if you want to talk about what is the real issue, I would refer back to my own testimony. The real fundamental question—not all these accounting gimmicks and not all of that. The real fundamental question is: Are we adopting policies that will increase our future productive capacity and our capacity to service the debt? That is the most fundamental question.

That is what I think our debate in the end ought to focus on. What is the best set of policies to assure that we can service this debt that we have. No one, I think, these days is suggesting that the United States ought to reduce its debt to zero as a percent of GNP. No going concern does that. A healthy entity can have debt and service the debt. The question is: Are we adopting policies which are going to allow the future generations who have to service some of that debt to be in a position to inherit an economy in a world where that debt can be satisfactorily serviced without adversely affecting other elements or their quality of life? That is what we should really be looking at. That was part of what I intended to try to emphasize in this testimony.

So I do not think it is at all fair to suggest that we are failing to look at this issue. I am saying, at least for my part, that is the fundamental issue. That is what we ought to be looking at.

Senator CONRAD. Well, my time has about run out, Mr. Chairman. I would just point out that I do not think we are focusing on it at all. We are talking about a target that is virtually meaningless in terms of the operating deficit of this country. The debt continues to build. We wonder why this country has gone from being the biggest creditor to the biggest debtor? It is because we are not facing up to the problem honestly. This is just more of the same.

I hope if there is a summit, that the leadership of this country—Democrats and Republicans—decides we are going to face the problem honestly. The first thing you ought to do is have an honest target. We do not have that, and we do not have one being put in front of us by the Administration.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you very much, Senator Conrad.

I think everybody has had one round of questions now with the witness, and I am going to have two quick questions here. Then I will defer to the distinguished ranking member.

Let us see that chart [1] we had a little earlier on the whole business of sequester. Put that up where Mr. Darman can look at that.

Mr. Darman, I have had a number of Senators indicate, well, why not just go to sequester when they look at the Bush budget. I thought I heard one of our more senior members of this Committee suggest that today in his discussion with you.

Let's look at this chart. The Bush budget is the heavy black bars, and the cross bars are what happens with the Gramm-Rudman-Hollings sequester. The bars on the left demonstrate that the present budget that we have before us cuts more deeply into entitlements than a sequester does.

It also indicates that if we go this nominal freeze route with these programs in the so-called "black box," we get heavier cuts in domestic discretionary than we do under a sequester. Then we look over and see what happens in defense, and we see that defense under a sequester really gets hit a hard lick. Whereas, under the Bush budget, according to our figures, it has real growth of about 1 percent.

Now, I will be frank to say to you that I do not want to go to sequester, and you have indicated publicly in times past that you do not feel it is in the best interest of the administration, or the American people, to go into sequester.

Now, my question to you is: Given the parameters of this Bush budget as we see it now, what do I say to my colleagues who say, well, look, if this is the only way we are going to get fair treatment on domestic discretionary funding and some of these entitlements, let us just go to sequester? How would you respond to that?

Mr. DARMAN. I would respond that they ought to encourage you in the process that you have started negotiating with the administration and your colleagues, because that is the way to produce a rational budget. Neither of these is rational.

If you are assuming our nominal freeze, which was strictly illustrative—we are not recommending the nominal freeze. If you are assuming that, that is as irrational as Gramm-Rudman-Hollings, which is a flat, across-the-board approach.

The only way to reach a sensible agreement with respect to those discretionary programs is to decide that some things really ought to go up, but some others really should not go up so fast; and maybe some others should not go up at all, they might go down.

Now, let me suggest a further thing, if I might. Among your colleagues, some of whom might say let defense take that big hit—

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[1] See p. 72.

but, of course, there are others on the Democratic side as well as the Republican who would say that that is irresponsible, do not let defense take that big hit. I would just note, among those who have the attitude let defense take that big hit, I would come back to them and say: But do you want to take that big hit in programs affecting drugs, the use of drugs? Do you want to take that hit that is on there with respect to Head Start, as Senator Wirth has just mentioned, or some of the environmental programs that he has expressed concern about and that others have expressed concern about? Or there has been some concern expressed about expending money for certain transportation purposes.

All of these areas would be hit if you had the arbitrary, across-the-board cut under Gramm-Rudman-Hollings, and they do not want that. So if they look at it seriously, at first blush they might say, sure, let defense take this big hit. I do not think that the majority in the Senate would favor that, but I think that some clearly might start with that view. Those people have to come back and look at what happens to those discretionary programs on the domestic side that they really care about.

Chairman SASSER. Well, here is what they say to me, and I do not mean to interrupt you, Mr. Darman. I think you have made your point there, and it is a point well made.

But here is what they say to me. They say, well, look, now the administration has paid for their programs, they have taken care of what they are interested in here, and they are giving them real growth or they are giving them a current services line or whatever you want to call it. Now, they want to get us over here and relegate us to arguing with them over where the cuts come in things we are interested in.

In other words, they are saying it is heads they win, tails we lose. So, Mr. Chairman of the Budget Committee, why should we listen to you? Let us just go to sequester and let the chips fall where they may.

Mr. DARMAN. Could I make two points, Senator?

Chairman SASSER. Yes.

Mr. DARMAN. Number one, I tried to say in response to an earlier question, I think from Senator Rudman, that I did not think negotiations should focus exclusively on the $136 billion. We have said what our priorities are. I took pains to say that others may have different priorities. The next logical step is for others to say what are their priorities.

Now, let us see. Can we reconcile some of these differences? Some areas, we will find common ground; other areas we will not. They all have that be part of the discussions.

We are not trying to say here it is, take it or leave it, these are our priorities, now it is up to you to fund them with things that you do not want to do. We are not taking that position at all. We have got a proposal. It is a coherent proposal. It is on the table. It says what we would like to see the money spent on. Now, let us look at alternatives, and then the process of negotiation moves forward.

Second and final point on this, I do not want to be misunderstood on one thing as to my own personal view. If we could not agree, I personally would favor our going to sequester notwithstanding all of the unattractive characteristics associated with it. I think it is not the responsible and sensible way to go, but I think it would be even more irresponsible to just let the system fall apart and have adverse reaction in financial markets if we could not reach agreement.

Chairman **Sasser**. One final question, and then I will defer to Senator Domenici.

I listened with great interest to the President's speech the other night to a joint session of Congress, and, frankly, I was encouraged by it. I was encouraged by the President's tone. And as Senator Johnston says, mood counts for something around here. For the first time in a long time, I heard a conciliatory tone, and he way saying let us together, with this Congress, address some of the deep, underlying problems that we perceive in domestic priorities in this country.

Yet when I started reading the fine print—and I think that we have got another chart here. If you will hold that up, this, I think, helps illustrate, at least for my purposes, what I am talking about.

When we look at this chart here, we find that some of these program areas that he is talking about—environment, the homeless, education, trying to combat drugs—these are the same programs that are scheduled for cuts that go in the "black box": $25 billion for education programs, $18.6 billion for health care, $17 billion for the environment, $8 billion in income support.

COMPOSITION OF THE BLACK BOX
($ in billions)

	1989 Outlays
Nondefense discretionary:	
Education, employment and social services	25.2
Health care (including veterans)	18.6
Transportation programs	20.7
Environment and natural resources programs	16.7
Income support programs	7.6
IRS and fiscal operations	5.8
All other (including justice, energy, commerce, housing, agriculture, community development)	19.6
Total nondefense discretionary	119.7
Defense	5.9
Entitlements & other mandatory	10.4
Total in freeze category	136.0

These are the things, it appears to me, that we are being asked to choose from here on the front end. If we do that, then all of the good will that this President I think gleaned from this Congress, on both sides of the aisle, with what I thought was, frankly, a very encouraging and good presentation, is at risk of going down the drain.

Mr. DARMAN. Senator, I hope that that good will is not at risk, and I certainly hope I have not in any way contributed to putting it at risk.

Chairman SASSER. I do not think you have wittingly.

Mr. DARMAN. May I make a comment about this chart, though, and its relationship to the President's remarks?

Chairman SASSER. Sure.

Mr. DARMAN. And I would be happy to get away from this $136 billion residual if you would like to look at the broader framework of the budget summit agreement for the discretionary programs, which would, in a way, be more logical.

If you take the first line on the chart—education, employment and social services—there are, of course, many program initiatives that the President offered that are not in that package, that he proposes to have increased. Now, maybe some would say that is not where they think those increases should be. They think those increases should be in some of the programs that are in the $136 billion. We are not saying we would not talk about that. We are saying that is exactly the kind of thing that should come up in the process of give and take.

We did not use the term "black box," and we did not create it, and we did not try to put a box around it. It is only a problem as long as you keep a box around it, and even with the box around it, it is only a problem to the extent that you measure against current services. It is not a problem, of course, measured against 1989 since we are saying for those programs not a cut, but the same amount as 1989.

But I am saying that is one option. Another option, which is really the spirit in which I think President Bush tried to put this all forward—and I should be putting it forward—is one that says: If you have got ideas for priorities that should be funded, we would like to see those; we would like to see if there is a way to work something out that adequately addresses what may be our competing interests in priorities, bearing in mind we all eventually have to meet the Gramm-Rudman-Hollings targets. That is the spirit in which I think we need to approach it.

Chairman SASSER. Senator Domenici.

Senator DOMENICI. I, too, have been sitting here for 3 hours and 25 minutes, and, frankly, while I think maybe we have taken an awful lot of time, I think it has been very healthy. I congratulate the members for coming and for their views.

I am somewhat amazed, however, at how each individual Senator can lament so laboriously and so emotionally about the status of our deficit and are so certain that we ought to do so much better. I invite them, Mr. Chairman, as we move through this process in the next 3 or 4 weeks, to make their proposals. If we are going to take social security out of this and have a new Gramm-Rudman set of targets, let us hear from some people. While economists are not scientists, as Mr. Darman indicated today, I have been heard to say they are more like religious leaders. They operate on faith and hope, and there is nothing wrong with that.

But I have not heard any of them, or any business leaders, suggest that really meeting the Gramm-Rudman targets, with whatever shortcoming—social security still being counted—I have not heard anyone say that is a disastrous economic policy. Quite to the contrary, I have heard them say: If you can do it, it is great. It is a good trend line for reducing this deficit.

Our problem is that we cannot even do that. It is not that we ought to do more or that we have been doing terribly. We do not know how to do even that much.

Frankly, let me say to you, Mr. Darman, I do not think you ought to leave here in any way apologetic for the President's approach as you have put it forth. Truly, if we can do as well as the President in his proposals, we will have a very good economic game plan moving for this country. Our problem is going to be that we cannot do some of the things that you recommend, and I am the first to tell you there are three or four I cannot support. But, collectively, we are going to work our will. Maybe we do not want to do the entitlement cuts that he recommends. Maybe we do not want the add-ons that he wants to add on, and you have tried to make that point here of late. Put the add-ons on the domestic side back into this discretionary pot, and you will see how much discretionary spending is going up. And if you do not want the increases, spread it out among the programs that are frozen.

Incidentally, I would submit for the record a list of budget authority increases and decreases in the discretionary accounts in order to have a zero outlay freeze, a whole batch of programs go up in budget authority and a whole batch come down.

[The information of Senator Domenici follows:]

Table 1 -- PROGRAMS IN THE DISCRETIONARY FREEZE BUDGET

THAT WOULD REQUIRE A REDUCTION IN BA RELATIVE TO 1989

($ in millions)

PROGRAM	FY 1989	FY 1990 BA Change
School Improvement Programs	1,217	-1,217
Dept. of Ed., Student Financial Assistance	5,814	-955
Vocational and Adult Education	1,073	-636
EPA, Hazardous Substance Superfund	1,425	-611
Compensatory Education for the Disadvantaged	4,579	-562
Education for the Handicapped	1,966	-507
HUD, Housing for Elderly or Handicapped Fund	429	-429
Mass Transit Formula Grants	1,605	-393
Bilingual, Immigrant, & Refugee Education	197	-351
Coast Guard, Capital Expenses	386	-294
ADAMHA	1,844	-255
DOE, Energy Conservation	315	-232
Interstate Transfer Grants, Transit	200	-200
National Park Service, Construction	198	-198
Corps of Engineers-Civil, General Construction	1,124	-177
Washington Metro	168	-168
Justice Assistance Grants	319	-157
EPA, Abatement, Control & Compliance	716	-153
SBA, Business Loan and Investment Fund	168	-149
Disease Control, Research, and Training	860	-126
HUD, Community Development Block Grants	2,650	-100
Appalachian Regional Commission Programs	111	-94
HHS, Human Development Services	1,339	-93
HHS, Health Resources and Services	1,424	-89
NOAA, Operations	1,257	-75
Ag., Cooperative State Research Service	338	-75
Dept. of Education, Library Assistance	137	-71
Veterans Medical Care	10,543	-69
Maritime Ready Reserve Force	111	-69
Miscellaneous Highway Trust Fund Appropriations	63	-63
Dept. of Education, Impact Aid	733	-61
Food and Drug Administration, Buildings	24	-59
DOE, Fossil Energy R&D	381	-54
Miscellaneous Highway Appropriations	55	-53
Tribal Health Administration	1,020	-52
HHS, Refugee and Entrant Assistance	382	-50
Community Service Jobs for Older Americans	344	-49
Fish & Wildlife Service, Construction	48	-48
IRS, Processing Tax Returns	1,763	-46
Export-Import Bank	695	-44
Labor, Training and Employment Services	3,783	-42
Dept. of Ed., Research and Statistics	78	-39
National Highway Traffic Safety Admin., S&E	68	-38
Federal Payment to District of Columbia	557	-37
Judiciary, Defender Services	110	-34
Vaccine Improvement Program Trust Fund	102	-33
Coast Guard, Alteration of Bridges	14	-33
Dept. of Ag., Agriculture Conservation Program	177	-32
EPA, Pollution Control R&D	152	-29

Table 2. -- PROGRAMS IN THE DISCRETIONARY FREEZE BUDGET REQUIRING AN INCREASE IN BA RELATIVE TO 1989

($ in millions)

Subfunction / Account		FY 1989	FREEZE FY 1990	CHANGE
304	Construction grants	1,950	3,505	1,555
609	SSI administrative costs	0	1,087	1,087
703	Construction, major VA	363	1,089	726
502	College housing loans	30	605	575
452	Rural water and wast grant	109	653	544
502	Higher ed	564	1,063	499
303	Urban park fund	0	356	356
401	RR rehab financing funds	0	341	341
274	SPR petroleum	242	432	190
551	Drug plug	(946)	(791)	155
453	Disaster relief	100	243	143
501	Drug plug	(355)	(219)	136
452	Ec dev asst	182	312	130
274	SPRO	173	283	109
271	Nuclear waste fund	364	470	106
403	Coast Guard ops	1,952	2,027	75
703	Construction, minor VA	112	185	74
401	Misc expired UMTA accounts	0	70	70
301	Op. & maint., general	1,200	1,267	67
702	Veterans job training	0	66	66
803	Investigation, collection & servic	1,475	1,542	66
302	Abondoned mine relamation fund	193	255	62
754	Drug Plug	(183)	(126)	57
601	Black lung fund	0	57	57
302	State and private forestry	87	142	56
271	Energy supply, R & D	2,142	2,196	54
376	S&E	109	156	47
301	Flood control, miss	338	382	44
401	NHTSA operations, trust fund	31	71	40
506	Homeless plug	(83)	(49)	34
352	Build and fac	16	48	32
301	Working capital fund	4	31	27
303	Ops of nat park system	735	761	27
705	Grants state VA cemeteries	9	35	26
276	S&E	420	443	23
801	Library buildings care	8	30	23
605	WIC	1,979	2,002	23
302	Management of lands	438	460	22
452	Construction	95	117	22
503	S&E	122	144	21
805	S&E	108	129	21
751	S&E	358	377	19
302	National forest system	1,348	1,366	18
502	Spec institutions for handicapped	79	97	18
503	S&E	211	229	17
271	Isotope production fund	0	16	16
506	Comm services block grant	381	395	14
403	Ship const	0	14	14
403	R&D	0	14	14
801	House office	29	42	13

Senator **Domenici**. Interestingly enough, we are wondering about WIC, and I am just going to give an example, and I will close with a couple of other points.

The WIC program is frozen. But, interestingly enough, in that discretionary box, there is an item called the urban park and recreation fund. The budget authority is up $356 million in order to arrive at an outlay level of $4 million, which is the same as last year's outlay level. We haven't funded this program for 6 years, there is $356 million in additional budget authority that you could use for WIC.

There are a whole list of programs that work that way. We have got to sit down and decide in bulk whether we can live with this kind of approach or not.

Now, my last point is going to be this: For those who think things are bad—and they may very well be—I can vividly remember sitting at this table right here when CBO estimated the 1985 Reagan budget with defense going up at about 8-percent real growth. The deficit that they estimated was $293 billion, saying if we keep those policies this year that we are in right now, the deficit will be $293 billion. There was even another economist and number-cruncher who said the deficit was $305 billion.

I think we have made some strides. The year before last, a budget was produced in Congress. Interesting budget. It had $22.5 billion in new revenues. The stock market crashed.

Incidentally, it would not have been very nice if we had our social security money invested in that stock market at that point for those who are saying we ought to invest it in the private sector. It would have been diminished by 25 percent overnight, and there would be war here, I guarantee you, had that been the case.

Nonetheless, $22 billion in new revenues, the market had its accident, "Black Monday." We went into a summit conference, and we passed new revenues of $9.5 billion instead of $22 billion. And lo and behold, we got the same deficit or better than was achieved under the $22 billion add-on in taxes. I do not know what it means. I merely state it. The $22 billion in taxes did not yield any better deficit reduction than $9.5 billion, after we went through the whole summit conference.

In the first year of the summit, we met the targets with $9.5 billion in new taxes. The second year was an election year, and there was a big slip—not between the numbers but between the processes around here. Before you got to the conclusion, a lot of money dropped through the cracks.

So, Mr. Chairman, let me suggest, I believe we have a responsibility on behalf of the President. We ought to go through this, and we ought to decide if we can reach the basic ingredients within his budget. We ought to be people enough to say where we cannot. If we cannot do the medicare cuts, there is $2.5, $3 billion we have got to find somewhere else. If we cannot do COLA's for seniors and the military—which I do not want—there is another $1.5 billion we have got to find somewhere else. If we cannot do post office—which I do not think we ought to do—there is a few hundred million more we have got to find.

Everybody is going to have those kinds of problems. Then we ought to decide where do we compromise, where do we negotiate.

If, in fact, we cannot achieve a compromise, then we ought to let the axe fall. You will really get the cuts if you have a sequester. One of the few times we really got budget authority diminished was when the House insisted on an experimental sequester. You know, they wanted a $20 billion sequester once, and we settled for $4 billion. And they called us chickens because we knew we could not do 1 year's worth of work in 3 months. So we did it. It turned out to be a disaster. It was not even $5 billion worth of sequester.

So maybe we ought to have that beast around. But, frankly, I close by saying to you, with your pledge of no new taxes, with your priorities that you listed in the campaign of the President of the United States, you have a reasonably good product. You should not be amazed if we do not agree with it in its entirety. But I think we ought to get on with producing something like it. And for those who want to do so much more, take social security out of this equation, set new Gramm-Rudman targets, boy, if we cannot get this one done by August or September, I just wonder how we would get the other one done in the full 2 years of this particular Congress.

Thank you very much, Mr. Chairman.

Chairman SASSER. Thank you, Senator Domenici.

Senator Boschwitz.

Senator BOSCHWITZ. Thanks, Mr. Chairman. I will be brief, too, so that Mr. Darman can get on.

I am sorry that Senator Riegle has left. I was somewhat shocked at the idea that he wanted to invest social security funds in highways and bridges and things like that. You know, those moneys are going to have to be paid back, too, by somebody. Certainly, we are not going to pay social security recipients in in cement. And, boy, the idea of selecting the investments, the social security recipients, if they were to hear what my friend from Michigan says, that we are going to select investments and use their funds for that, boy, we would be here late at night on a whole lot of nights.

So I will talk to him about that and talk to my friend from North Dakota, too, about whether or not we really are the largest debtor Nation. If we are the largest debtor Nation, why do we still have more income from our investments abroad than we pay foreigners who invest in this country? But those are things that I will take up.

Everybody has a few of them. My friend from New Mexico has said whether it is the post office or some other thing in which he feels this budget has not exactly reflected his viewpoint. And because all of us, indeed, do have a few things that are our favorites or are the subject of our committee, it is very hard to do the budget.

That is the reason I some years ago took up the so-called fair play budget which says everything rises but by an exactly equal percentage, which is hard in the medical programs, to be sure, with the technology that is developing. It is a little arbitrary, but I think that there has to be some arbitrariness in the budget if we are going to be able to control it.

I look forward to working with you, Mr. Darman, and I myself have sat here only 2 hours because I came a little bit late from Minnesota. But I do look forward to working with you.

I have found, Mr. Chairman, that Mr. Darman in the past is not afraid of making decisions and getting to the point. And so I think that we do have an opportunity, and that he is negotiable. So that we do have an opportunity to do something that will be satisfactory to both the Administration and ourselves, and hopefully, that will continue that trend line that the Senator from New Mexico has spoken about.

I thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Boschwitz.

Mr. Darman, you mentioned in your opening statement that you provided all the necessary data to estimate a current services baseline. This is true but only in total. We are still missing some of the pieces to complete the puzzle, and our staff here, my staff, has prepared a short list of information that is needed. Could you have your staff respond to this request in a timely fashion?

Mr. DARMAN. I have not seen it, but I am sure we will do our best. Yes, sir.

Chairman SASSER. Do you have anything further?

Senator DOMENICI. I just wanted to make one 30-second observation.

Mr. Darman, this is just gratuitous advice. As this President starts his 4 years, I think people are suggesting that he take an in-depth look at where we are and where we are going. I recommend to you strongly that I do not believe this budget and the fiscal plan included in it is the only thing you ought to be looking at. I really believe you ought to seriously look at the overall American set of activities—what people do, how business invests—and see if there is something else that others might be doing differently that are more calculated to produce goods and wealth and be more competitive.

I do believe there might be something beyond the deficit, of a cultural nature, of a discipline nature, that we ought to be looking at, because clearly we are no longer alone out there. We have got a whole batch of centers of economic activity. And to the extent that they may be doing better, we ought to find out why. It is very complex. I really urge that somebody be looking at that in an in-depth manner.

Thank you, Mr. Chairman.

Mr. DARMAN. Could I make one comment, Mr. Chairman?

Chairman SASSER. Yes; Mr. Darman, you are using up your own time here, so you go right ahead.

Mr. DARMAN. I just wanted to respond to Senator Domenici. I agree with him completely. In fact, in the general spirit of cooperativeness and warmth and kindness and gentleness and so on, I may have lent myself to the portrayal of a problem that some would think is worse than it really is. Just following on Senator Domenici's point, my own personal view is that we are very, very likely to be able to reach agreement on a deficit reduction program that meets the Gramm-Rudman requirements. It will take a lot of work and back and forth and all the normal things it takes, and it will be difficult along the way. But I think we will get there.

I think it would be a mistake—I hope this is in the same spirit as you had in mind—I think it would be a mistake to think that just doing that will be sufficient to address some of our long-term interests which are not adequately addressed through the budget. There are cultural variables. There are issues affecting productivity, which I think is one of the most fundamental elements in this equation; issues affecting productivity that are not going to be significantly altered by some of the decisions we make with respect to that little pot—it is not there any more—or any others.

So I would agree with Senator Domenici. We ought to have our eye on some of these larger issues, I would call them larger issues—"other issues" is maybe what we should say—other issues as well. We are starting some studies in that direction, and some of these topics are serious enough that we will not have a quick answer. We may not even have a right answer, but we are at least starting down that path.

I would hope that by the time we have a budget to present a year from now, or less than a year from now, the next budget cycle, that some of the special analyses could begin to at least raise some of these broader questions that are not affected by mere crude indicators such as the Gramm-Rudman-Hollings deficit reduction line.

So I applaud the interest, and we will be trying to do some things that move us in that direction.

Chairman **Sasser**. Thank you very much, Mr. Darman. And I would just add that I, as chairman of the Budget Committee, am concerned very much about the budget deficits and am concerned about the corrosive effect of the deficits on our economy and on our standard of living in the future.

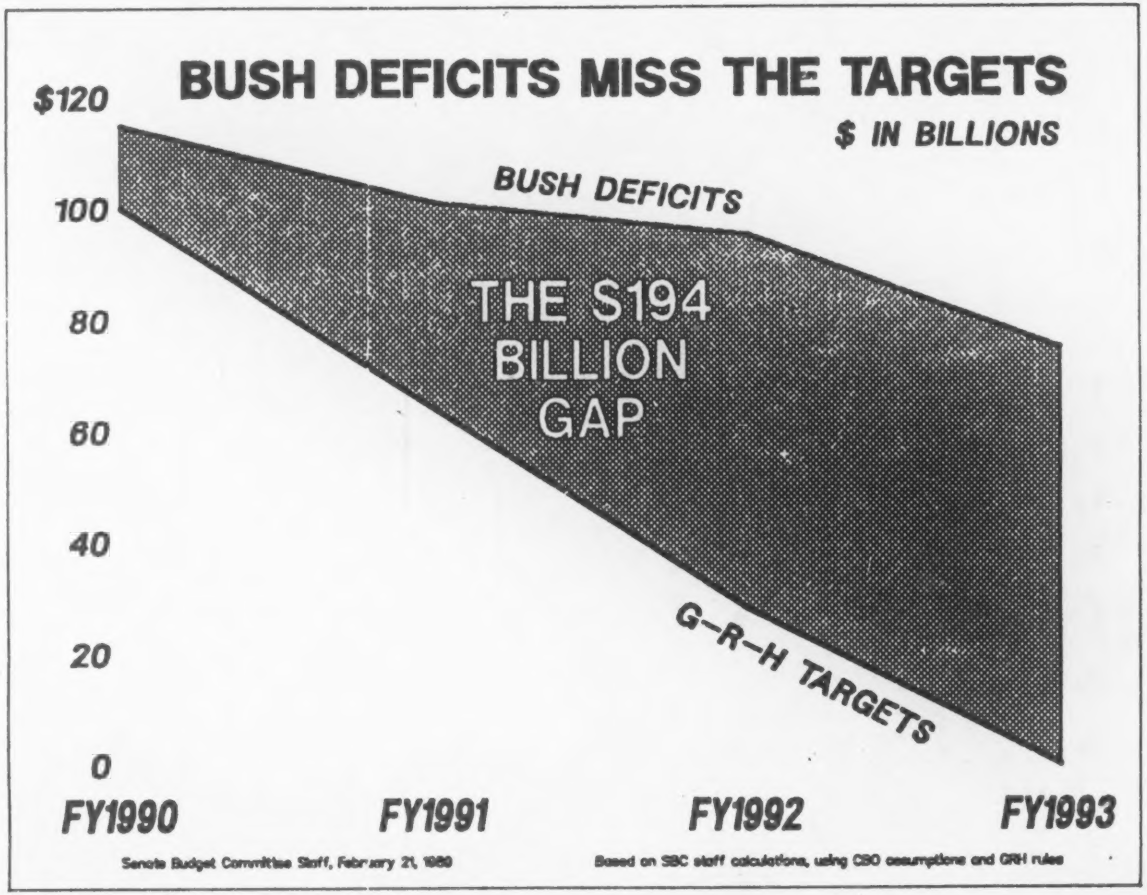
I think we need to move as expeditiously as possible to try to reduce the deficit, to get the deficit under control. We have made some progress. We have still got a long, long way to go. And simply because we meet Gramm-Rudman-Hollings targets for this year does not mean that we have made the kind of progress that I think we really need to make. Those are absolute total minimum standards, and we need to find a way to keep this economy growing. We need to find a way to stimulate savings in this economy. I think one of our most crying needs is for capital.

We appreciate very much your appearance here this morning, Mr. Darman. You have been very patient and exhibited considerable discipline today here under sometimes very strenuous questioning. You are to be commended for that. We are going to go forward here with our process in the Senate. We are going to continue our hearings. We will be looking forward in the future to a markup, while at the same time we will be engaging in ongoing discussions with you and your colleagues from the Executive Branch, I am sure.

If there is nothing further here, I declare these proceedings closed.

Mr. **Darman**. Thank you very much, Mr. Chairman.

[Whereupon, at 1:45 p.m., the committee adjourned subject to the call of the Chair.]



BUSH DEFICITS MISS THE TARGETS

Senate Budget Committee Staff, February 21, 1989

Based on SBC staff calculations, using CBO assumptions and GRH rules

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COMPARISON OF CHANGES IN DEFICIT
BUSH, REAGAN AND GRH SEQUESTER
(in billions of dollars)

	Bush	Reagan	Sequester
Defense 1/..................	2	5	-10
International Discretionary..	(*)	(*)	-1
Entitlements................	-13	-18	-4
Domestic Discretionary.......	-8	-5	-8
Net Interest................	-1	-1	-1
Total Proposed Spending Changes...................	-19	-19	-24
Revenues....................	-6	-1	---
User Fees...................	-5	-6	---
Asset Sales.................	-4	-6	---
Total Deficit Reduction....	-34	-32	-24

1/ Defense numbers adjusted for military retirement accrual

THE UNBUDGET

Fully Specified:

Social Security
Federal Retirement
Science and Space
Selected Bush Initiatives :
  Federal Aviation Administration
  Head Start

Numbers Without Policies:

Defense
Agriculture
Medicare
Medicaid

Unspecified:

"*Black Box*"
Superfund
Community Development Block Grants
Compensatory Education
Women, Infants, and Children
Vocational Education
Reagan Terminations

The Bush Budget: Promise vs. Performance

BUSH PROMISE	**BUDGET REALITY**
o Expand funding for maternal and child health	o No money for Medicaid increase, other programs frozen
o Full funding for means-tested entitlements	o AFDC, SSI, Food Stamps operating costs frozen
o Support and increase adoption assistance	o Foster care and adoption assistance (mandatory) frozen
o Act now on acid rain and environment	o No new money for acid rain, clean air, hazardous waste, or ocean cleanup
o $1 billion in new outlays for fighting drugs	o Less than half is new funding

YEAR-TO-YEAR CHANGES IN BUSH 1990 BUDGET OUTLINE

(BILLIONS OF DOLLARS)

YEAR-TO-YEAR REVENUE INCREASE	+$82.7
YEAR-TO-YEAR DEFICIT REDUCTION TO MEET BUSH DEFICIT	-$71.0
OUTLAY GROWTH ALLOWED UNDER $99 BILLION BUSH DEFICIT	+$11.7

YEAR-TO-YEAR OUTLAY SAVINGS

FUNDS FREED UP FROM NATURAL DECLINE IN MANDATORY PROGRAMS	$10.0
OFFSETTING COLLECTIONS INCREASE	$5.2

NET AVAILABLE YEAR-TO-YEAR OUTLAY GROWTH	+$26.9

YEAR-TO-YEAR OUTLAY GROWTH

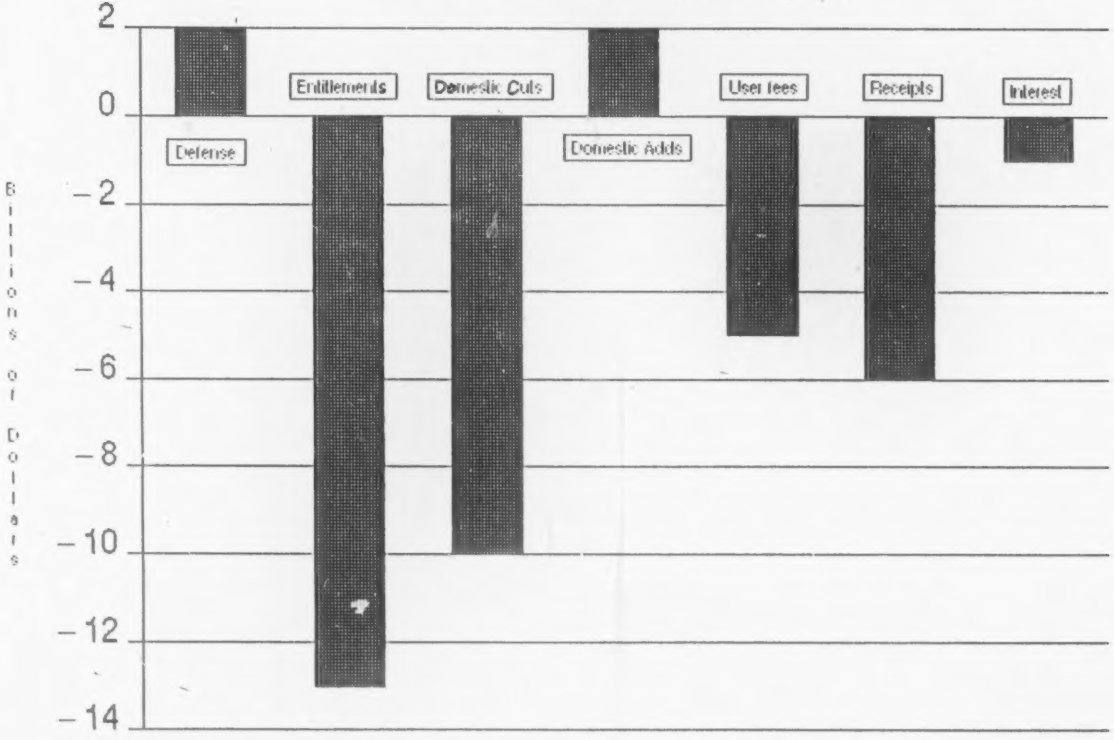
NET INTEREST	+$5.0
SOCIAL SECURITY	+$14.3
NON-DEFENSE INITIATIVES	+$6.2
DEFENSE INCREASE	+$2.1

REMAINDER AVAILABLE	**-$0.7**

REMAINING PROGRAMS, INCLUDING:
- **MEDICAID AND OTHER MEANS-TESTED ENTITLEMENTS**
- **MEDICARE**
- **RETIREMENT PROGRAMS**
- **ALL OTHER DOMESTIC DISCRETIONARY PROGRAMS**
- **ADMINISTRATIVE COSTS OF ENTITLEMENT PROGRAMS (INCLUDING MEANS-TESTED)**

Priorities in the Bush Plan

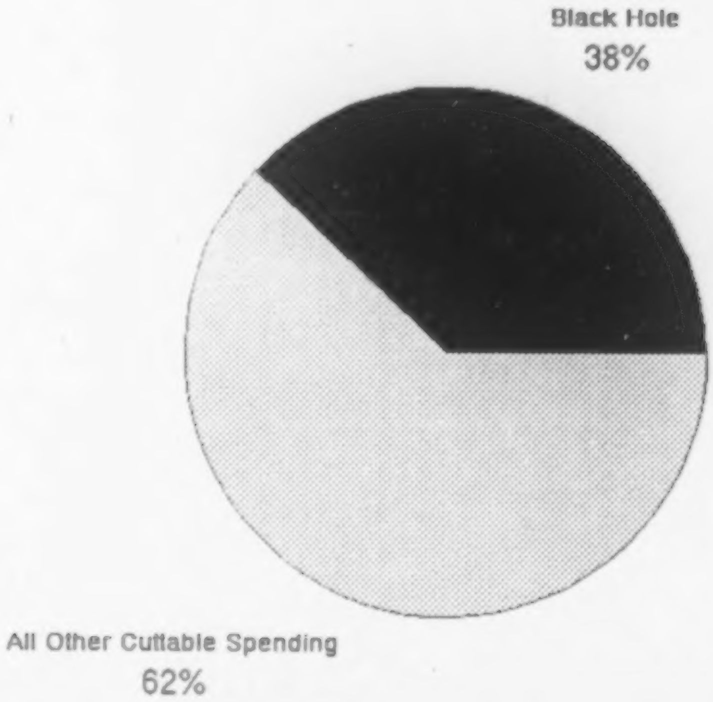
Deficit Changes by Category

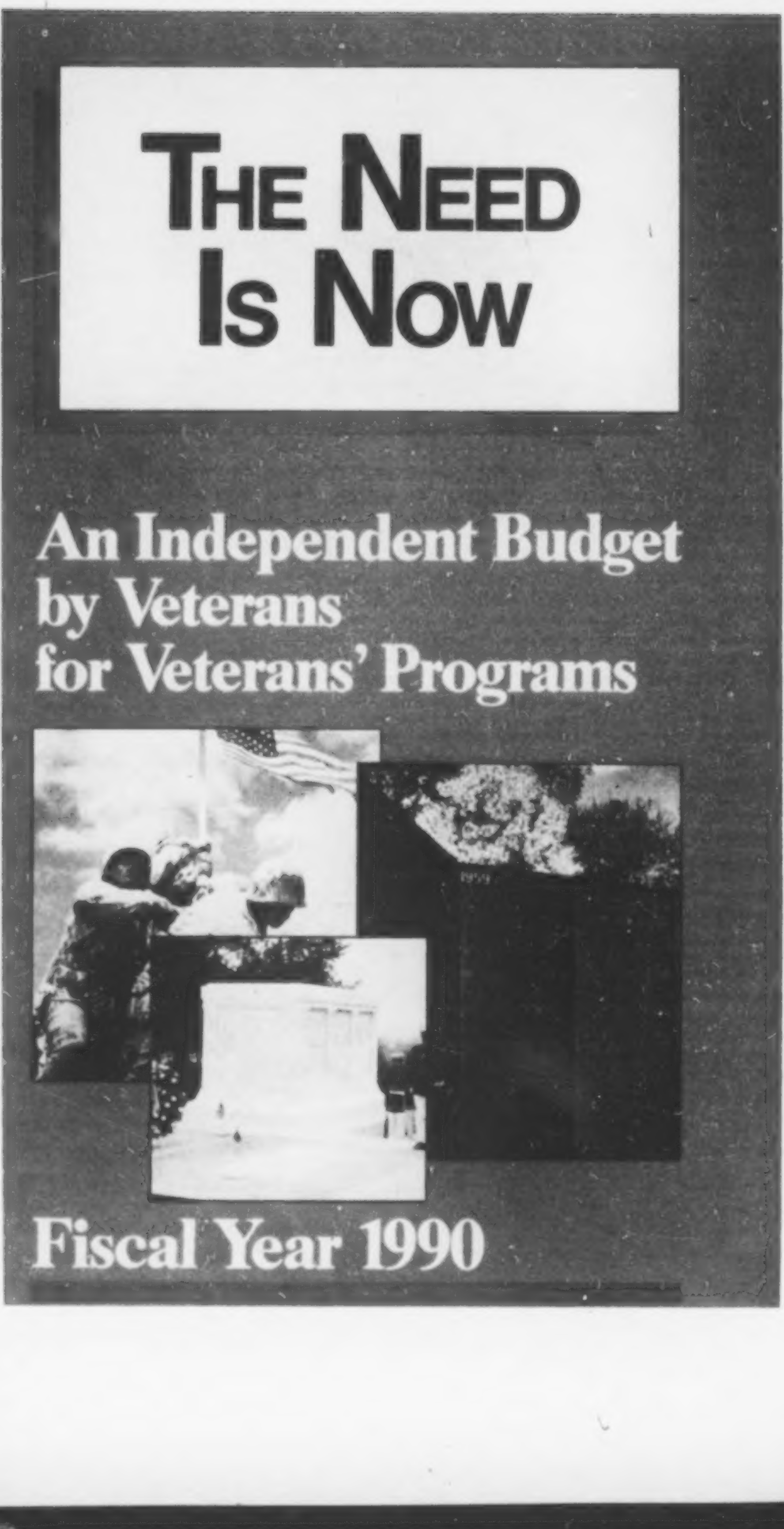


Senate Budget Committee Staff

February 21, 1989

The "Black Hole" as a proportion of Cuttable Spending





THE NEED IS NOW

An Independent Budget by Veterans for Veterans' Programs

Fiscal Year 1990

PROLOGUE

This budget proposal is respectfully submitted to the Congress, which, over past years, has labored hard and long to provide an adequate budget for veterans' programs. This document, covering the main issues in the Veterans Administration Annual Budget, is the product of a combined effort of four major Congressionally Chartered Veterans' Service Organizations. This collaborative effort connotes a final loss of confidence in OMB's intention or ability to address veterans' issues objectively or to support the moral and legal obligations that this nation has accorded the men and women who have served our country.

The serious erosion of the discretionary components of the Veterans Administration budget are of primary concern to the authors of this document. Veterans, who have given of themselves in defense of our country and for the continued assurance of the liberty and security of their fellow citizens, surely have earned top priority for their benefits--equal to, if not greater than, the recipients of any other federally sponsored socioeconomic or health care program. Veterans benefits must enjoy the same protection as that accorded to social security recipients.

Jimmy T. Smith
National Commander
American Veterans of World
War II, Korea and Vietnam

Billy E. Kirby
Billy E. Kirby
National Commander
Disabled American Veterans

John H Michaels
John H. Michaels
National President
Paralyzed Veterans of America

Larry W. Rivers
Commander-in-Chief
Veterans of Foreign Wars
of the United States

INTRODUCTION

For the past two years, four Congressionally chartered Veterans Service Organizations (VSOs) have joined in a cooperative effort to develop and present to Congress a budget proposal addressing the program requirements of the Veterans Administration (VA). We are again this year taking this proactive approach to place on the record the perspective of the Congressionally chartered consumer representatives of our nation's veterans, independent of what we consider the flawed budget process of the Office of Management and Budget (OMB).

The Independent Budgets (IB) have been well received in Congress and the VSOs are particularly gratified that last year's submission was considered an effective counterpoint to the Administration's FY 1989 budget request. The Veterans Affairs Committees of the Congress have stated that they need and want the VSOs to continue to prepare and submit an Independent VA Budget.

During its short history, the Independent Budget has become an integral part of the VA budgetary legislative process. The VSOs are, of course, encouraged by the Congressional response, but also recognize that the Independent Budget is so essential because the Administration's budget requests have lost their credibility.

The 1989 Independent Budget identified major problems in the delivery of service to veterans and articulated the premise that, to a great extent, the Administration's budget process was responsible for those problems. The underlying theme of the 1989 Independent Budget was that the Administration's budget proposals did not reflect a realistic assessment of the problems now facing veterans. This makes it virtually impossible for VA personnel, responsible for delivering services to veterans, to provide cost-effective solutions to those problems.

The 1989 IB provided a detailed analysis of the state of each program administered by the VA and assessed its effectiveness in terms of the VA's ability to provide the level of service to veterans intended by Congress with the then current funding. This analysis established that there has been continuing deterioration in resources to provide the quality and timeliness of service to veterans by the VA and that this deterioration was linked directly to the budget construction process. Equally disturbing was the obvious presence of a generalized demoralization of VA personnel caused by OMB's arbitrary budget cuts.

The 1989 IB made a number of recommendations which were designed to reverse the trend of declining service and provide an environment within the VA where past levels of service could be restored. In making these recommendations, the VSOs were fully mindful of the climate of budget austerity; therefore the recommendations required only a minimal percentage increase in funding. Because they were not funded, some are presented again this year along with other initiatives to improve the quality and timeliness of service by providing VA personnel with resources that realistically could be expected to increase their productivity and job knowledge, not only in the immediate future, but more importantly for the long-term as well. This, the VSOs believe, is what the budget process should be about--providing the best possible services with the least possible resources.

The VSOs are equally aware this year that fiscal constraints on the federal budget must continue. We have repeatedly assured Congress of VSOs willingness to accept decrements in veterans' program funding providing those cuts are equitably applied to all other programs. Where discriminatory budget cuts are made, they must surely be based on valid priorities. Veterans, who have given of themselves in defense of their country and for the continued assurance of the liberty and security of their fellow citizens, surely have earned top priority for their benefits--equal to, if not greater than the recipients of any other federally sponsored socioeconomic or health care program. Veterans benefits must be protected in the same way benefits for social security recipients are protected by the Administration.

We have taken care, in the development of this document, to exercise responsibility and restraint. All recommendations are based on measured need. We hope those needs can somehow be met.

The traditional and proper role of the Executive Branch agency is to provide Congress with accurate data on the amount of appropriations that are necessary, given effective management and employee efficiency, to provide no less than adequate service to veterans in accordance with Congressionally directed programs. The Congress needs this type of budget formulation to appropriate funds wisely and responsibly. If funds are simply not available to provide this level of service, even with reasonable productivity improvements, Congressional decisions must be made, after expert input from the VA, on where budget cuts will have the least negative impact on veterans.

It is agonizingly clear to the VSOs that this commonly accepted and rational approach to budget making has been turned on its head by the OMB. Budget cuts are predetermined and made in the vacuum of the insular world of numbers. Budget formulation by VA managers reflecting their real needs in providing service to veterans has become a futile exercise. Their voice falls on deaf ears at OMB. Because needs are too often ignored or obfuscated by OMB in their final budget document, Congress is deprived of this essential input. The result is a budget process that is divorced from reality because it has little relationship to the real needs of real people. The process feeds on itself, becoming even more detached from the real world when the Administration attempts to justify it. Thus, when confronted with the litany of facts which demonstrate grossly inadequate service due to grossly inadequate resources, the Administration states the false promise that funds requested are sufficient to provide adequate service; this leads to the equally false conclusion that the level of service to veterans must, therefore, be adequate. This flawed process has become so entrenched that decisive action must be taken to break the vicious circle.

In this FY 1990 Independent Budget, we document the sorry state of service to veterans with more than statistics. We describe actual results affecting real people which have been caused by the erosion of the VA resource base. Most glaring, perhaps, is the admitted denial of needed medical care to eligible veterans and the deteriorating quality of care accorded others.

Last year's Independent Budget not only voiced the concerns of veterans, it also incorporated the concerns of VA managers and employees with the budget process--whose concerns are otherwise muted. The VSOs have every confidence that VA employees have the talent, information, dedication and motivation to provide the quantity, quality and timely service which veterans deserve, given adequate resources. Their frustration, however, must be as great as that of the VSOs because not only have they not been provided with the tools necessary to do their jobs, they lack the means to obtain them through an obviously flawed budget process. The VSOs, therefore, feel compelled to speak for them.

The urgency of the FY 1990 Independent Budget cannot be overstated. By any standard, service to veterans is at an all-time low. Given the current situation, the VSOs believe that a fundamental change in the budget--making process must occur if this situation is to be corrected. The VSOs take satisfaction in Congress becoming more directly involved in the assessment of VA staffing and resource needs and also directing that essential management initiatives be implemented.

However, the FY 1989 Administration budget proposal, with its woefully inadequate appropriations request for the delivery of essential service to veterans, was the continuation of a long-term practice of unrealistic budget submissions. The problem is that the existing process does not take into account the cumulative damage inflicted upon veterans by a series of ill-advised budget requests.

Rather, each year's request is considered separately with current services being defined by adding funds for some, but not all, uncontrollable new expenses to the eroded resource baseline of the previous year. The shortfall is then compounded by further purely arbitrary cuts. The fact is, however, that even if proposed cuts are not accepted by Congress, the basic problem is nonetheless perpetuated because a continuation of an ever diminishing "current service" level can only result in further service deterioration. Yet another year in this vicious cycle will be nothing short of disastrous.

For these reasons, it has become increasingly important that Congress be more directly informed in the particulars of the VA budget. The fundamental question is the level of appropriations actually needed to deliver an adequate level of service to veterans and their families, irrespective of OMB's unrealistic budget request.

As before, the format of this document generally follows that of the official federal budget of the

Veterans Administration. We deal only with accounts for which VA appropriations are required, not with those that are self-financed or financed by other agencies. The text in each broad budget component contains a list of principles and guidelines, statements of the challenges facing the VA, our strategy to address those challenges, and our specific recommendations. Insofar as possible, we have eliminated "boilerplate" verbiage, but we make use of narrative material to explain programs and policies. Legislative proposals described in this document are being separately submitted. All policies and recommendations in this Independent Budget have the unanimous concurrence of all participating Veterans Service Organizations.

We are appreciative of the VA's helpful response to our Freedom of Information request for management data in the public domain. It has enabled us to conduct independent analyses of VA programs and utilization trends, better identify veterans' needs and make informed judgments regarding the administration of medical and other benefits programs, and VA construction. Information on which the views and recommendations contained in this document are based was not, however, limited to VA reports. Information from other federal and private sources and studies was also used. In addition, we undertook systematic, in-depth discussions with top management in VA regional offices and medical centers, and incorporated feedback from veteran constituents.

The VA program managers and providers of veterans' services, be it health care or other benefits, are to be commended for functioning as well as they do under the very trying circumstances stemming from short staffing and short funding.

The Congressionally Chartered Veterans Service Organizations respectfully submit this fiscal year 1990 Independent Budget proposal for Congressional consideration and look forward to providing further testimony on its behalf.

THE BUDGET IN BRIEF

This is a veterans' budget for veterans developed by four major Congressionally Chartered Veterans Service Organizations (VSOs): American Veterans of World War II, Korea and Vietnam (AMVETS), the Disabled American Veterans (DAV), the Paralyzed Veterans of America (PVA), and the Veterans of Foreign Wars (VFW). In this budget, we have been both fiscally prudent in our recommendations and responsive to veterans' real needs in our proposals.

THE CHALLENGE

Three principal challenges shape our budget this year. One is the increasing demand on VA programs that stems from the aging of the veteran population. The largest group of veterans, the World War II and Korean War generations, is now rapidly reaching age 65 and over--ages at which health care needs and death rates increase dramatically. This aging process, the first challenge, results in a need for more services from the VA's health care system and from its cemetery and memorial affairs programs.

The second challenge facing the Independent Budget is to reverse the progressive erosion of the resources necessary to provide veterans their earned benefits. We find that over the past several years this erosion has been a common administration response to veterans and has now reached crisis proportions in all general program areas. While the erosion of the resource base associated with veterans programs is having a severe negative impact on the ability of veterans to receive these benefits in a timely and qualitative manner, this erosion, which has occurred over several years, now presents a need for vastly improved funding to meet program requirements. In medical care, this underfunding is causing severe cutbacks in several program areas which in turn is threatening quality of care and the ability of the VA to optimally support its affiliation program.

The third challenge is that of veterans' unmet need for VA services. Unmet need appears in the Veterans' benefit area, where severe deficiencies are found in services provided to veterans; these result primarily from understaffing of the Department of Veterans Benefits (DVB), the VA unit that administers benefits programs. We have also found evidence of multiple types of veteran unmet health care needs across the VA system.

OUR STRATEGY

The basic strategy of the Veterans Service Organizations that have authored this Independent Budget is:

> To assure that all veterans receive the benefits and services to which they are entitled;
>
> To assure that the VA provides benefits and services in a manner that is cost-efficient and timely;
>
> To assure the integrity, quality, and appropriate integration of the benefits and services the VA provides; and
>
> To pursue the establishment of a more exact and rigorous budget formulation process to assure that Congress recognizes the need for and appropriates the funds necessary to support legislated programs/benefits.

In light of the need for austerity, an important component of our strategy consists of confining our initiatives to actions dealing with veterans' most urgent needs, and proposing to meet these needs in the most economical fashion possible.

On the other hand, the shortfalls in funding that have accumulated over the past several years must be eliminated before permanent irreparable damage occurs to veterans' benefits. This brings about the need for a considerable infusion of funds in this period of budget austerity.

Our overall strategy recognizes that total veteran benefit program costs increase less rapidly than does inflation because of the declining number of program beneficiaries in the largest benefits programs (compensation and pensions). All such savings should be regarded as available to meet the growing need for health care services that arises as the veteran population continues to age.

In the benefits administration area, our strategy is directed primarily at improving the service the VA is providing. We seek service in the adjudication of claims that measures up to standards of timeliness and quality of the late 1970s, as well as comparable improvements in other important service areas. This will require (1) an increase in staff; (2) the installation of appropriate computer systems in the VA and their integration across departments of the VA; and (3) the establishment of needs-directed training programs that will develop, maintain, and upgrade the skills of the benefits program staff.

Veterans are willing to shoulder their share of the burden of deficit reduction. We will thus accept a curtailed cost-of-living adjustment (COLA) in 1990 in veterans' benefits programs if all other federal program beneficiaries--including Social Security recipients--do likewise and if there is a similar curtailment of federal contract cost increases due to COLAs in contractor employees' wages. Otherwise, we call for a full and equitable COLA increase in veterans' benefits programs. Our strategy for benefits also calls for putting the loan guaranty program on a sound financial footing as a VA-operated program.

In the medical programs area, our strategy is to attack current problems of unmet need and to meet growing need in the future by increasing our emphasis on less expensive care modalities. In particular, our recommendation is for more reliance on non-institutional forms of care, which are generally far more economical than are institutional modalities of care. The VA has recently achieved impressive shifts toward non-institutional care in the mix of care it delivers, and our strategy calls for still further shifts in this direction. And, in order to provide quality care to our veterans, the VA must use state-of-the-art equipment, and adequately staff VA facilities. To keep the health care system functioning at an acceptable level will require additional funds just to eliminate serious shortages that now exist and to preclude such shortfalls in future years.

Our strategy in Medical and Prosthetic Research is to reestablish and maintain a more adequate, stable and assured resource capability to halt the VA's deteriorating ability to fund high quality research proposals.

Our primary strategy in Medical Administration is to plead for the MAMOE budget the necessary resources and program authority to meet the imperative of protecting, in all of its ramifications, the access to and quality of VA health care.

Our strategy in VA construction starts with the necessity of maintaining the system of VA health care facilities, assuring that they are in good repair, and that functional space is updated to keep up with changes in health care delivery technology and needs. In addition, we call for the development of a system that will realistically assess the need for construction and include a sound system for setting construction priorities. Our strategy also calls for an expansion of the National Cemetery System to make burial plots available in reasonable proximity to veterans' families.

GENERAL RECOMMENDATIONS

Tables 1 and 2 show the funding we recommend in the appropriation accounts into which the VA budget is divided. These tables show that most of the increase we recommend is required merely to keep even with rising costs. This has not occurred in the past and is evidenced in the large increases shown for current services.

Total appropriations for the VA in FY 1988 were $28.3 billion. Just to maintain the same level of program activity in FY 1989 would require $29.7 billion. This concept of maintaining the same level of program activity as in FY 1988 is what we mean by "current services." The dollar increase from FY 1988 to FY 1989 needed to maintain current services (i.e., to maintain the FY 1987 level of services provided) is large--about five percent. Providing this increase is obligatory if the VA is to continue to provide the level of services in FY 1990 as was provided in FY 1988.

Unfortunately, as the tables show, the FY 1989 enacted appropriations total about $500 million dollars less than the FY 1989 current services level (i.e., less than the amount necessary to continue to provide the FY 1988 level of services). We call for appropriation of the additional amount needed to reach the current services level in FY 1989 so that the VA can continue to provide the services it has offered in the past. If these additional funds are not appropriated, a considerable cutback in medical care, medical research, and in grants to states for extended care facilities will be required. Further, there will accrue an enormous backlog of applications for various veterans benefits that will not be processed for lack of staff.

In turn, the FY 1990 current services level is $31.3 billion, about $1.6 billion above the FY 1989 current services level. The 1.6 billion increase must be funded just to allow the VA to continue to operate in FY 1990 as it did in FY 1988.

As part of our computation of the current services level, we include amounts necessary to cover pay raises, and we are recommending these amounts be appropriated in full, at the beginning of each fiscal year--not late and not partial, as has too often been the case in the past, resulting in staffing cuts and corresponding reductions in needed services for veterans.

Our total recommended VA appropriation level for FY 1990 is $32.1 billion, about $800 million above the FY 1990 current services level. Thus, as is fitting in an era of austerity, most of the funding increase we recommend is required merely to cover increasing costs, not to support new initiatives. Our major recommendations for FY 1990--including managerial recommendations with relatively small budget impact--follow.

RECOMMENDATIONS FOR GENERAL OPERATING EXPENSES - BENEFITS ADMINISTRATION

Because service to veterans has worsened from already unacceptable levels with existing DVB resources and there is every indication that deterioration of service is accelerating, there is a critical need for the additional resources recommended in the FY 1989 Independent Budget. Supplemental appropriations for FY 1989 are therefore recommended for:

Increased staffing in areas of DVB where shortages are most critical, i.e., Veterans' Service Compensation, Pension and Education; Loan Guaranty; and Vocational Rehabilitation and Counseling. Increased staffing for FY 1990, in addition to the FY 1989 supplemental, is recommended for Compensation, Pension and Education.

Enhancement of DVB's existing automated systems while the VA proceeds with its promised, but delayed, integrated systems modernization plan.

Improved training for DVB employees, again concentrating on DVB functional areas in which training limitations have led to the most severe problems.

TABLE 1
VA APPROPRIATIONS SUMMARY
(dollars in thousands)

Appropriation Account	1988 Appropriation	1989 Appropriation	1989 IB Current Services*	1990 IB Current Services*	1990 IB Recommended Appropriation
General Operating Expenses and Misc.	774,810	783,320	830,460	873,960	910,160
Benefits Programs	16,571,300	17,063,670	17,123,670	17,497,400	17,497,400
Medical Programs	10,409,960	10,843,140	11,268,600	12,422,640	12,770,540
Construction Programs	522,900	500,640	501,540	502,540	921,920
TOTAL VA APPROPRIATION	28,278,970	29,190,770	29,724,270	31,296,540	32,100,020

*Funds necessary to maintain services at the FY 1988 level

TABLE 2
VA APPROPRIATIONS BY ACCOUNT
(dollars in thousands)

Appropriation Account	1988 Appropriation	1989 Appropriation	1989 IB Current Services*	1990 IB Current Services*	1990 IB Recommended Appropriation
GENERAL OPERATING EXPENSES AND MISCELLANEOUS					
General operating expenses	774,810	774.320	821.460	867,960	904.160
Grants for the construction of state veterans cemeteries	0	9,000	9.000	6,000	6,000
TOTAL GOE AND MISCELLANEOUS	774,810	783.320	830,460	873,960	910,160
BENEFITS PROGRAMS					
Compensation,pension, and burial benefits	14,832,400	15,460,600	15,460,600	15,685,600	15,685,600
Readjustment benefits	808,200	619,800	619,800	434,100	434,100
Veterans insurance and indemnities	14,300	13,470	13,470	13,900	13,900
Veterans'job training	0	0	60,000	0	0
Loan guaranty revolving fund	916,400	969,800	969,800	1,363,800	1,363,800
TOTAL BENEFITS PROGRAMS	16,571,300	17,063,670	17,123,670	17,497,400	17,497,400
MEDICAL PROGRAMS					
Medical Care	10,129,660	10,542,500	10,952,500	12,094,200	12,424,900
Medical and prosthetic research	192,900	210,240	224,700	235,000	249,200
Medical administration and miscellaneous operating expenses	46,600	47,900	48,900	50,940	53,940
Grants for Construction of State Extended Care Facilities	40,320	42,000	42,000	42,000	42,000
Grants to the Republic of the Philippines	480	500	500	500	500
TOTAL MEDICAL PROGRAMS	10,409,960	10,843,140	11,268,600	12,422,640	12,770,540
CONSTRUCTION PROGRAMS					
Construction, major projects	403,000	363,040	363,040	363,040	634,920
Construction, minor projects	116,000	111,600	112,500	113,500	275,000
Parking garage revolving funds	3,900	26,000	26,000	26,000	12,000
TOTAL CONSTRUCTION PROGRAMS	522,900	500,640	501,540	502,540	921,920
TOTAL APPROPRIATION	28,278,970	29,190,770	29,724,270	31,296,540	32,100,020

*Funds necessary to maintain services at the FY 1988 level

Direct the VA to complete the study ordered by Congress on a nationwide toll-free telephone service which should take into consideration the Social Security Administration's experience in implementing such a service.

Every support should be provided to ensure the continued integrity of the Veterans Loan Guaranty Revolving Fund.

We concur with the Administration's proposal that the Veterans Mortgage Life Insurance Program be funded within the Veterans Insurance and Indemnity Program rather than through Burial Benefits and Miscellaneous Assistance.

The VSOs suggest that it is particularly appropriate, now that the VA is to receive cabinet level status, to transfer to the VA all of the functions of the Department of Labor's Assistant Secretary for Veterans' Employment and Training.

RECOMMENDATIONS FOR BENEFITS PROGRAMS

Recommendations that will require more than nondiscretionary appropriations for benefit payments are:

A cost-of-living adjustment (COLA) effective December 1, 1989 in benefit programs that is equal to the COLA applied in other federal programs. The VSOs are prepared to support a reduced or delayed COLA as a deficit reduction method if it is applied across the board; and

A FY 1989 supplemental appropriation of $60 million for the Veterans' Job Training Program. Authority to fund $60 million for this account was provided for FY 1988 and FY 1989 through P.L. 100-322, which extended the program to September 30, 1989. However, appropriations to fund this legislation were not requested by the Administration.

The VSOs strongly support congressional efforts to provide long-term solutions to the problem confronting the Loan Guaranty Revolving Fund;

The VSOs support the Administration's proposal to fund the Veterans Mortgage Life Insurance program within the Veterans Insurance and Indemnities appropriation rather than through Burial Benefits and Miscellaneous Assistance; and

A proposal to consolidate all functions relating to veterans employment issues under the Department of Veterans Benefits rather than maintaining the current split responsibility for these functions between the Department of Labor and the Veterans Administration.

RECOMMENDATIONS FOR MEDICAL PROGRAMS

Fully fund cost increases necessary to assure current services are maintained at the FY 1988 level. Serious reductions in medical care will result in FY 1990 if further erosion of the resource base, as occurred in the FY 1989 budget, is not compensated for by replacement and annualization of the current dollar shortfall.

The specious OMB practice of exacting an annual 1 percent budget decrement for presumed personnel productivity improvement should no longer be tolerated by Congress.

There should be an end to OMB sub rosa budget reduction made via arbitrary and excessive assumption about the amount of expected slippage in facility activation dates. A more realistic slippage factor based on the last several years of actual experience must be applied.

While holding constant the targeted inpatient workload and in recognition of still further shift to more cost-efficient ambulatory care, 23.7 million outpatient visits should be anticipated for FY 1990.

The need is underscored to provide increasing additional funds to meet the VA's high cost of the growing AIDS epidemic.

The VA should not resort to a rationing of health care to veterans in order to operate within a budget shortfall. Supplemental budget requests in FY 1989 should precede such action.

We urge a more comprehensive survey, than any previously conducted, be designed and administered to a national sample of veterans for the purpose of identifying their health status, their health care needs, the source through which those needs are being met, their unmet medical needs and the potential the VA offers for meeting those unmet needs. Specifically, we recommend that the Institute of Medicine be solicited for a study proposal.

We again urge the Congress to expand outpatient care entitlement to all Category A veterans based on the same rules of access to health care as apply to in-patient treatment. It is time to eliminate the confusion and provide continuity of quality care to entitled veterans.

As requirements for veterans' benefits programs decrease with the aging of the veteran population, savings so derived should be regarded as funds available to meet their increasing health care needs.

We suggest Congress should request of the VA annual reports on the progress of designing and incorporating outcome evaluation instruments in their quality assurance program.

All recruitment and retention incentives available need to be utilized to counteract the critical shortage of VA health professional personnel. This issue is discussed in some depth in this Independent Budget document, especially emphasizing the enhancement of ongoing VA education and training programs. Three personnel--related legislative proposals also address this need.

The VA should be persuaded to step up the realignment of its health care facilities to better accommodate the long-term care impact of the aging veteran. This especially includes a more rapid conversion of excess hospital beds to nursing home units and targeted increases in non-institutional extended care programs.

The VSOs recommend that the VA identify at least one small secondary type care hospital, in geographic proximity to a tertiary care referral VAMC, for total conversion to a prototype multilayered extended care center complete with ancillary geriatric programs for full continuity of service and liaison with community long-term care facilities and programs.

The VA should be encouraged to be more flexible in the optional use of innovative programs to maintain a proper balance of modalities to meet the demands of a changing health care environment.

Funding should be provided for the expansion of Geriatric Research, Education and Clinical Centers (GRECCS) to the authorized number of 25 over the next three years. Correcting the time table slippage in acquisition of these units will come close to having a GRECC in every one of the VA's 27 medical districts.

The remarkable success of sharing agreements between VA and Military Medical Services warrants expansion wherever mutual interests are to be served.

To help correct the alarming shift of funds and deterioration of patient care in the DM&S Prosthetic and Sensory Aids Service, the entire PS&AS budget should be fenced and controlled through centralized allocation.

RECOMMENDATIONS FOR MEDICAL AND PROSTHETIC RESEARCH

We are recommending a research appropriation to restore the resource level depleted by recent budget erosions and provide a renewed vitality to pursue answers to some of the most pressing medical problems ever faced.

RECOMMENDATIONS FOR MEDICAL ADMINISTRATION AND MISCELLANEOUS OPERATING EXPENSES (MAMOE)

The DM&S Central Office has never been so ill prepared to suffer any further budget absorption of uncontrollable expenditures. We submit that Medical Administration is already marginally staffed to manage the multiple crises stemming from under funding and under staffing throughout the VA health care system. The VSOs feel it is imperative that the MAMOE budget be restored to a valid current services level, with full funding of all unavoidable additional expenditures anticipated throughout the coming budget year. The only incremental request beyond a true FY 1990 current services level has to do with the need for increased funding of AIDS related education.

RECOMMENDATIONS FOR CONSTRUCTION PROGRAMS

An appropriation level of $275 million for minor construction reflecting the importance of updating and repairing VA facilities, primarily treatment facilities, the bulk of which were constructed in the decade of the 50's.

An appropriation level of $635 million for major construction, almost entirely devoted to medical treatment facilities, reflecting the VSOs urgent concerns for the unacceptable erosion of this vital element of the national infrastructure.

Prompt development of an adequate planning system which would permit the VA to project available construction dollars against a rationally devised national construction strategy which prioritizes requirements for construction and repair.

Within major construction, an appropriation of $6 million to begin to buy land for cemeteries that will have to be added to the National Cemetery System to meet what the VSOs see as a minimum acceptable level of available and accessible burial space.

Within major construction, $40 million for advance planning and design funds to keep projects moving forward efficiently.

Within major construction, $30 million for 4 new 120-bed VA nursing homes each year. Within minor construction, $40 million to be earmarked this year for conversion of existing VA hospital beds to nursing home beds, with a projected requirement to fund $20 million for this purpose annually through the year 2000.

LEGISLATIVE PROPOSALS

We are submitting, separately, legislative proposals on the following subjects:

Increase VA incentive bonus pay for physicians by a figure which corrects for inflation since the legislative enactment of 1979;

Provide entitlement to all Category A veteran patients for the full array of outpatient services;

Authorize and fund an associate degree education program for VA employees for training in various health care disciplines. Candidates should receive full VA salaries during a two-year academic schedule along with tuition, books and related fees. Two years of obligatory service should be required for each year of academic support;

Mandate that the VA establish a veterans' cemetery in every state;

Transfer of all veterans' benefits programs to the Department of Veterans Affairs, i.e., veterans' employment program transferred from DOL to DVA; and

Support re-introduction of S 2462, a bill by Senator Cranston which proposes funds to health professional schools affiliated with VA medical center to increase the number of students entering VA staff "shortage areas."

RECOMMENDATION FOR ESTABLISHING CONGRESSIONAL SUBCOMMITTEES

With the creation of the Department of Veterans Affairs, we recommend that the Appropriation and Budget Committees of the Congress create subcommittees for Veterans Affairs. This is important in terms of the new status of veterans programs and the budget impact of veterans programs which approximate $30 billion per year.

RECOMMENDATIONS FOR A REVISED BUDGET FORMULATION PROCESS

The VSOs recommend that Congress direct the VA to establish specific goals in its budget justification that represent the level of service to veterans and their families that are to be provided with the appropriations requested. The budget analysis supporting the appropriations requested should include the VA's assessment of how the resources provided will be used to meet stated goals.

VIEWS OF OUTSIDE ECONOMISTS

WEDNESDAY, FEBRUARY 22, 1989

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Exon, Sanford, Fowler, Conrad, Armstrong, Symms, and Grassley.

Staff present: John L. Hilley, staff director; and Chuck Marr, junior economist.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

I want to welcome before the committee this morning a very distinguished panel of witnesses. Gentlemen, we are delighted to have you and appreciate your coming and joining us today.

As we begin, our attendance will be somewhat sparse at the outset. Three of our members are having to chair major committee hearings this morning in Banking, Commerce, and Energy. A number of our members are having to attend the Energy Committee hearing, including Senator Domenici, which concerns the confirmation hearing of the new Secretary of Energy, but we expect Senator Domenici here, shortly, and with his approval and acquiescence we are moving forward this morning to begin to take testimony, in the absence of our Republican members who will be coming shortly, we are advised.

Today, the Senate Budget Committee continues its hearings on the budgetary policies of the Bush administration.

Our focus today, however, will not be on the particulars of the budget. Rather, it will center on the economic consequences of building an economic policy based on deficit spending.

The economic statistics tell us a clear and compelling story. The economic legacy of the 1980's is one of a massive buildup of public, private, and foreign debt. Budget deficits have tripled since 1980, and the publicly held national debt has soared from $709 billion in 1980 to $2.1 trillion currently.

The debt of nonfinancial corporations has increased by over $800 billion, or 80 percent in the last 5 years. Debt loads of far too many corporations have reached staggering proportions.

Household debt has increased from 63 percent of total personal income in 1980 to 74 percent of personal income in 1988.

Now let's be clear about it. The Federal Government is not responsible for all of this increased corporate debt or increased household debt, but the Federal Government has certainly set a very bad example, and, with its misguided fiscal policies, has led the way for this massive new indebtedness.

The massive deficits of the last 8 years have reached the point where fully 75 percent of the private savings have been consumed by Federal budget deficits. Thus, there is precious little domestic savings left over for private investment.

From 1950 through 1979, domestic savings was adequate to finance our investment, and there was no need to go to foreign capital to fuel our economic growth.

But from 1980 through 1987, the net domestic savings rate as a percent of gross national product fell by 3 percentage points, and now, at least one-third of the financing for our investment comes from overseas. In short, it appears to this Senator that our misguided fiscal policies provided us with a very painful fiscal dilemma. Run a deficit and slash private investment, or run a deficit and borrow foreign capital to finance the buildup of our economy.

This Nation took the path of least resistance. We borrowed foreign capital in massive amounts. As a result, we now have the largest international debt. It is projected to be more than $500 billion at the end of this year. At the rate we are going, we will have a larger effective debt-to-income burden than Brazil by 1990, and as we all know, Brazil has its financial affairs managed by the International Monetary Fund.

The deficit debate is not just a debate about dollars and cents, what goes into or what is cut out of a budget. The deficit debate has far more profound dimensions. It is a debate about our future standard of living. It is a debate about our relatively economic power in world affairs.

We see that many of our trading partners and trading adversaries, and countries such as Japan, finance their economic growth from internal sources. That shows that over time such economic policies redound to their benefit.

For me, the choice is a clear one: borrow now and you will most assuredly pay later with a lower standard of living and a diminished economic standing in the global order.

Save now, invest now, and just as surely you will gain later with a higher standard of living and a strong voice in world affairs.

In larger terms, this is what the 1990 budget debate is all about, and I trust that the President and the Congress will keep this in mind as we attack the damage inflicted by the deficit policies of the 1980's.

We are pleased this morning to be joined by our distinguished colleague from Colorado, Senator Armstrong.

Senator **ARMSTRONG**. Thank you, Mr. Chairman.

Chairman **SASSER**. Senator Armstrong, we welcome you and would turn to you, if you have any opening comments at this time.

Senator **ARMSTRONG**. Mr. Chairman, I do not have a prepared statement, but I do want to congratulate you on your observations about the danger presented by the continued, and very large Federal deficit.

In fact as you were speaking, I could not help thinking of the first of this series of hearings before this committee which I participated in 11 years ago, and in fact some of the things which you have expressed so eloquently I expressed less eloquently and in a more—well, in a rougher fashion 11 years ago, and I was seated way down at the end of the table.

And the fact of the matter is that one of the reasons I am optimistic about the future of our economy is because things which some of us expressed 10 or 11 years ago, and which were generally the object of ridicule at the time, have emerged as kind of a consensus view.

And there was sort of an opinion when we expressed a concern that the deficit was a very, very serious problem, that somehow this was an unfounded fear.

In fact I remember vividly some of my colleagues, including one or two who are still members of the committee, that, in essence, laughed at such concerns, and it is reassuring to me to hear the chairman of this committee express in such forthright terms the need to get the deficit under control.

I thank you for your courtesy, Mr. Chairman. I am looking forward to reviewing the testimony of the witnesses.

Chairman Sasser. Thank you very much, Senator Armstrong.

Today, we are joined by Dr. Benjamin Friedman, a nationally recognized economist. He is a professor at Harvard University in the Department of Economics.

He is the author of a very profound new economic treatise, "Day of Reckoning." We are pleased to have Dr. Friedman with us today.

We also have Dr. David Jones, a Ph.D. from the University of Pennsylvania, a senior vice president with Aubrey G. Lanston & Co., Inc., and is an advisor to the Federal Reserve Board.

And we are pleased to have these witnesses joined by Dr. Charles Wolf, the distinguished director of the RAND Corporation Graduate School, and of RAND's research on international economics, and a recognized expert on international economic policy.

Gentlemen, we welcome you before the committee this morning, and we look forward to your views and comments, and Professor Friedman, we will start from my left and go to my right, and we will begin with you this morning, if that is satisfactory.

STATEMENT OF DR. BENJAMIN M. FRIEDMAN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Dr. Friedman. Thank you very much, Mr. Chairman. I am grateful for the privilege of coming before this distinguished committee to summarize my views on these extremely important issues confronting the country as we now contemplate Federal Government budgets for a new administration.

If I may, I would like to summarize, briefly, the statement that I have prepared, rather than read the entire statement. I think that would save some time.

Chairman **Sasser**. Please do so, Professor Friedman, and your full statement will be included in the record as if read.[1]

Dr. **Friedman**. Thank you, Mr. Chairman.

The question that I believe this committee must face—and, behind this committee, that the country must now face—is whether President Bush's proposed budget provides an adequate framework for making progress on the problem that you identified in your opening remarks, Mr. Chairman, and that Senator Armstrong also highlighted in his remarks.

I believe the answer is no. We need to do substantially more to address this problem than the President has proposed in his budget. To summarize my remarks, I would like to talk first about why the budget deficit is a problem, both to our national economic health and to our international standing, and then about why the President's plan, as proposed so far, is, I think, inadequate. Finally, I would like to offer some general guidelines on where we should go from here.

First of all, why is the budget deficit a problem? I believe there are two principal reasons. The first, which you highlighted, in particular, in your remarks at the opening of the hearing, Mr. Chairman, is that the budget deficit absorbs a large fraction of our national saving. That is saving which, once the Federal Government absorbs it, is not then available to invest in business plant, equipment, machinery, research, and the whole variety of other productivity-enhancing investments.

It is no accident that, at the same time that the Federal Government's budget deficit has absorbed a record high fraction of our national saving in the 1980's, we have also slipped in the amount of our income that we are investing in business plant and equipment. Measured on a gross basis—that is, inclusive of replacement of depreciating assets—our investment in the 1980's has been high on average but only because it started high in 1981. Gross investment as a share of our national income peaked in 1981, and it has been declining ever since. Measured on a net basis—that is, excluding replacement for depreciating assets—we have, quite simply, devoted a smaller share of our national income to investment than we did in the 1950's, or the 1960's or the 1970's.

I believe that is the principal reason why our productivity performance throughout the 1980's has been very disappointing, and that, in turn, is why we are now seeing the first economic expansion in 50 years in the United States in which the real wage of the average American worker is going down.

Second, I think the budget deficit is also a problem because, as we draw in foreign saving to replace our private saving which is absorbed through Government borrowing, we have impaired the competitiveness of our economy; and, in the long-run, we are also impairing our ability to project the democratic values and democratic institutions, for which the United States has always stood, around the globe.

We have had trade deficits—that is, excesses of what we import over what we export—that have dwarfed anything that would have been considered imaginable back in the days to which Senator Armstrong referred a while ago. At the outset of the 1980's, there was only one economist, to my knowledge, who even contemplated, in public, a trade deficit as high as $100 billion. Today, anybody who predicts a trade deficit as low as $100 billion is considered a wild optimist.

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[1] See p. 185.

At the same time, we have to remember that foreign producers do not simply contribute these cars and watches and computers, and VCRs to us. The United States is not an eleemosynary institution receiving charitable grants. They sell us those goods, and in the process we are slowly converting the United States from what we used to be the world's largest creditor country, providing our investment capital to other countries around the world, and enjoying the unique status and privilege that has historically gone with that position, into the world's largest debtor country, evermore dependent on the kindness of strangers.

The current discussion of these issues in the media, and sometimes among the public at large, has been plagued with a variety of misconceptions, too many to address carefully here, but I would like to take up three in particular.

The first is the claim that there is no connection between the absorption of our national saving through Government budget deficits and our ability to invest in productivity-enhancing capital. That claim usually goes something like this. Other countries—Japan is the typical example—have ratios of Government deficits to their national income that are in excess of ours, yet they invest more.

The answer, of course, is that Japan has traditionally been a high saving country. By contrast, we have traditionally been a low saving country. If we saved what the Japanese save, as a share of our national income, then, we also could have a higher Government deficit and afford to invest more as well. We do not save what the Japanese do, however. We never have, and there is nothing in the economic evidence to date, or in the experience of Government policies, that bears the remotest suggestion that we know how to increase our saving rate to anything like the Japanese level.

Senator **Fowler**. Are there factors other than cultural ones involved with the Japanese? Why do they save so much more? Is there anything in Government policy that encourages this?

Dr. **Friedman**. International comparisons of savings rates, Senator, is a very complicated subject. For example, some people point to the different retirement arrangements in Japan, and say that, if we had the absence of Social Security that they did, then we would save more; but that comparison immediately breaks down when we compare ourselves to Germany, because the German retirement system is, if anything, even more extensive than ours. Ours was, after all, modeled after the German system.

So simple comparisons along these lines break down. The one piece of evidence I can describe to you, that is at all new, is that we had a thesis at Harvard several years ago in which the student tracked the saving behavior of second and even third-generation Japanese-Americans, through an elaborate survey. It was a very energetic piece of work. What our student found was that, down to the third generation, Japanese-Americans do save substantially more than non-Japanese Americans do, on average, for the same income level, and comparable general socioeconomic status.

That is a long way of saying that economists simply do not know why the Japanese save more.

The second important misconception I would like to mention is that we are now using the Government's deficit to finance productivity-enhancing investment. People point out that the use of borrowing to finance investment is no more than what any sound business does. If the Government were borrowing in order to put in place roads, highways, bridges, port facilities, research facilities, and so forth, then we could at least discuss whether those infrastructure investments might even be more enhancing of productivity than more business machinery. Similarly, if we were using the deficit to support manpower training, to educate the labor force for a role it will have to play in the future, when more and more American workers will work either in the high-technology goods-producing sectors or in the information-processing sectors of our economy, that also would be an issue.

But ironically, at the same time that the Government deficit has risen to a record high, compared to our national income, the fraction of our Government spending that goes to civilian infrastructure investment and other similar activities has hit a record low in the 1980's.

The third misconception I would like to address is that the deficit has already declined substantially and, on our current trajectory, is likely to continue to do so.

The principal part of this misconception has to do with the inclusion—contra to legislation of some years earlier, but consistently with the Gramm-Rudman legislation—of the Social Security surplus in the unified budget deficit. We have heard quite a bit lately about how the deficit has come down from $221 billion in fiscal year 1985 to just—and I put the word just in quotation marks—$155 billion last year. But last year's performance was actually a combination of a $41 billion surplus in the Social Security account and a $196 billion deficit for everything else that the Government does.

The administration's projections for the current fiscal year show yet a further deterioration in the general account deficit. Unless we are willing simply to look the other way, as we undo the solution to the Social Security problem that Congress legislated in 1983, we therefore do have a severe and mounting problem.

Now let me quickly turn to the President's plan and ask whether the so-called flexible freeze on Government spending, with no new revenues, will solve the problem. I believe that it will not.

One reason, which has already attracted an overwhelming amount of attention in the national press and therefore needs no further emphasis here, is the set of economic assumptions upon which this plan is based. There was a time, I would bet, when most members of the Senate Budget Committee, upon hearing the words, rosy scenario, might have thought that was some new actress. That time is past. We have had nearly a decade of experience with being told that we would grow out of the deficit. It is no more accurate to believe that now than it was 2, or 4, or 6 years ago.

Second, the budget proposals put on the table by Mr. Bush conform to what I regard as a very unfortunate aspect of the Gramm-Rudman-Hollings legislation—namely, they include the Social Security surplus in pointing to a trajectory for a lower deficit. Unfortunately, in the current deficit discussion, the phrase, "I support the Gramm-Rudman targets," is a code phrase which means, "I favor undoing the solution to the Social Security problem that we achieved several years ago."

Finally, there is an inherent unworkability——

Chairman SASSER. If I can interrupt there just a moment, Professor Friedman. So you favor undoing the Social Security fix that we did a few years ago?

Dr. FRIEDMAN. No, Mr. Chairman. I believe that if we follow the Gramm-Rudman targets—and, again, the Gramm-Rudman targets explicitly include the Social Security surplus in the concept of the deficit to be used as the Gramm-Rudman benchmark—that is a recipe for undoing the solution to the Social Security problem. Merely supporting the Gramm-Rudman targets as a long-run trajectory for our budget problem is, I believe, therefore equivalent to undoing the 1983 solution to the Social Security problem. But, no, sir, I certainly do not favor that.

The third problem with the President's plan is that there is an inherent unworkability in the flexible freeze concept as it has been described so far. Let me make this point by citing two examples.

First, interest payments. On some descriptions, interest payments are included in the part of the Federal budget that, under the flexible freeze, would be allowed to grow at no more than the rate of inflation. If that is right, and if the administration's very optimistic projections for interest rates in the future—namely, that they will come down, even in the face of a projected sharp acceleration of growth—turns out to be wrong, then we will find, after the fact, that we did not keep to the flexible freeze. By contrast, on other descriptions, interest payments are excluded from the flexible freeze concept. In that case, whether the flexible freeze will or will not solve the budget problem is crucially dependent on the whole range of economic assumptions used, like the administration's projected combination of strong growth and lower interest rates.

A second example, which is much in the news lately is the President's plan for bailing out the savings and loan associations. As an interesting exercise on the airplane coming down this morning, I looked to find the largest number in this one day's newspaper for what it might cost to solve the savings and loan problem. The answer was $200 billion, compared to the $120 billion stated in the President's proposal.

Now, I do not know what is the right number, but suppose, for the moment, that the President's estimate is too optimistic. That means that, after the fact, as we spend more money than projected to bail out savings and loans, we will discover that we have violated the flexible freeze unless, perhaps half way through a fiscal year, we find additional spending cuts to offset the higher bail-out fees.

My guess is that when this committee meets in February 1993 and addresses the issue of whether the flexible freeze worked, or not, in the 4 years of the Bush administration, the answer will be it did not work because it was never tried. And that will be right.

But the reason why we will say it was never tried is that, in this very important sense of including uncontrollable expenditures within a total that is supposed to be kept fixed, the plan is simply unworkable at the outset.

Where, then, do we go from here? I think we need to do three things.

First, I think we need to have genuine restraint on Government spending. I suggest spreading that restraint over as broad a range of Government programs as possible. Anybody who claims that there is no possible area in which to cut Government spending should simply read the new Congressional Budget Office book on budget options, which includes 111 options for cutting Government spending. It is a matter for our elected Senators and Representatives to work with the President in deciding which of those that we should pick, but it is just wrong to think there is no way to cut spending.

Second, because I do not think we are going to find enough spending cuts to solve the problem we now face, I therefore think we will also need some increase in taxes. Despite all of the rhetoric about welfare queens and bloated bureaucrats, and 8 years' worth of hunting for waste, fraud, and abuse, the basic fact is that more than three-fourths of all Government spending goes for only four programs. Those are defense, social security, medicare/medicaid, of which by far the biggest piece is medicare, and interest on the debt. So, unless one is contemplating a large assault on one or more of those four programs, there are no really big dollar items left. Even the remaining one-fourth of Government spending includes such items as drug enforcement, law enforcement, the immigration authority, the courts, the prisons, our embassies abroad, the interstate highways, the space program, and so forth. For this reason, I believe that solving our problem will require some combination of spending restraint and revenue increase. Finally, even though I realize that monetary policy is not the particular interest of this committee, if we are really going to have enough spending restraint and enough tax-revenue increase to solve our problem, I believe we will also have to have an easier monetary policy—translated, that means lower interest rates—in order to avoid a recession.

Mr. Chairman, I am very grateful for the opportunity to present my views to the committee. Thank you very much.

Chairman SASSER. Thank you, Dr. Friedman, and we will come back to you later for some questions which I have, and I am sure the other members have.

[The prepared statement of Dr. Friedman follows:]

February 22, 1989

TESTIMONY BEFORE THE UNITED STATES SENATE

COMMITTEE ON THE BUDGET

Benjamin M. Friedman
Professor of Economics
Harvard University

Mr. Chairman:

I am grateful for the opportunity to present my views to this committee as it assesses prospects for the U.S. Government's budget under current tax and spending policies, and evaluates potential alternative actions.

America now has a critical economic problem. The federal government's fiscal imbalance is sapping our ability to be productive at home and to compete abroad. This corrosion is already stunting the growth of our standard of living. It is also already compromising our influence in world economic affairs. If left unchecked, it will continue to do both.

The heart of the problem is that, on average during the Reagan years, the government's borrowing to cover its budget deficit has absorbed three-fourths of the net saving done by all individual Americans and all American businesses combined. With so little of our private saving left over for private use, we have devoted barely two cents out of every dollar of our national income to net investment in business plant and equipment -- less than in the 1950s or the 1960s or the 1970s. As a result, productivity gains have been disappointing

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This testimony draws in part on my recent research and writings, including especially Day of Reckoning: The Consequences of American Economic Policy Under Reagan and After (Random House, 1988).

(apart from the usual all-too-brief cyclical surge just after the 1981-82 recession ended). And without productivity growth, business cannot pay higher real wages. As by now we have so often heard, the current economic expansion is already the longest in U.S. peacetime experience. But it is also the first economic expansion in fifty years in which the average working American's wage has gone not up but down compared to inflation.

Fixing the problem -- not in the sense of cancelling our accumulated debts, which is impossible, but of at least stopping the hemorrhage by freeing up America's private saving to be available once again to finance private investment -- will require making some hard choices. Those choices will be the more difficult because of the widespread perception of economic prosperity. But our country's prosperity today is actually a false prosperity, an illusion built on borrowing from the future. When President Reagan took office our federal debt (not counting what the government owes to itself) was $738 billion, or 26 cents for every dollar that the country produced and earned. The United States was also the world's leading creditor nation, with the power and influence that that privileged position has historically carried with it. But eight years of a radical new fiscal policy -- all years of peacetime -- have nearly trebled federal indebtedness, while the national income not even doubled. The net federal debt is now approximately $2.1 trillion, or 43 cents for every dollar of our income.

Worse yet, after seven years of reckless borrowing the United States is now the world's largest debtor nation, ever more dependent on the good will of the countries that lend the money to keep the party going. It is surrendering the ownership of its productive assets, not in exchange for assets it will own abroad, nor to build other new facilities at home, but merely to finance systematic overconsumption. Having stunted its investment at home and dissipated its assets abroad, the nation now faces difficult choices because, unless it acts quickly to reverse these forces, we and our children will pay the consequences in the form of a diminished standard of living and a far different role for America in world affairs.

Although President Reagan consistently blamed Congress for the deficits that averaged $180 billion per year during 1982-88 (the 1981 budget was still President Carter's), the difference between the spending that Congress voted and what he proposed -- including defense and non-defense programs -- averaged only $17 billion. Even if Congress had adopted each of the Reagan budgets down to the last dollar item, the deficits and the economic problems that they have caused would have been not even ten percent smaller.

The real cause of the deficits the government has run during these years was that Congress approved the Kemp-Roth tax cut, which Mr. Reagan strongly supported, without matching spending cuts that neither Congress nor the President was willing to propose. As a result, we have had an economic policy that artificially boosts consumption at the expense of investment, dissipates assets, and runs up debt. We are enjoying what appears to be a higher and more stable standard of living by selling our and our children's economic birthright. With no common agreement, nor even much public discussion, we are determining that today should be the high point of American economic advancement compared not just to the past but to the future as well.

This decision to mortgage America's economic future has not been a matter of personal choice, but of legislated public policy. Popular talk of the "me generation" to the contrary, most individual Americans are working just as hard, and saving nearly as much, as their parents and grandparents did. What is different is economic policy. The tax and spending policies that the U.S. Government has pursued throughout the 1980s have rendered every citizen a borrower, and every industry a liquidator of assets. The main reason that the average American has enjoyed such a high standard of living lately is that since January 1981 our government has simply borrowed more than $20,000 on behalf of each family of four.

It is ironic, but probably true, that we would be more likely to address these problems if their consequence were some immediate economic cataclysm. The American political system has always been best at responding to crises. During the weeks when it looked as if the October 1987 stock market crash might be just such a crisis, prospects that the government might actually do something about its fiscal imbalance temporarily brightened -- only to fade as the fears themselves faded.

Defenders of the policies that have caused this imbalance have argued that the resulting overconsumption and underinvestment has had no serious implications, and will have none in the future, precisely on the grounds that there are no tangible, readily visible adverse consequences to which one can point. This argument is wrong, in that it ignores the stagnation of real wages in the current expansion, as well as the episodic loss of influence that our new status as a debtor nation has already brought. It also ignores the devastation of our agricultural sector and many of our key manufacturing industries -- autos, steel, electric machinery -- in the years when the U.S. government's borrowing drove interest rates here above those abroad, and therefore made dollar investments so attractive that the dollar became heavily overvalued. It also ignores other industries' continuing loss of sales to countries where production costs are lower, in part because we have underinvested.

Even so, it remains true that the most important costs of our current fiscal policy are not dramatic and obvious, but subtle and gradually corrosive over time. In many respects, that aspect of our nation's current problem is the most challenging of all.

Costs of Continuing Large Deficits

The unprecedented splurge of consumption financed by borrowing in the 1980s is eroding America's future prospects in two ways, each of which carries deep implications not just for our standard of living but for the character of our society more generally.

The more straightforward cost of our current economic policy is no more, and no less, than what any society pays for eating its seed corn rather than planting it. The federal deficit has averaged 4.2 percent of U.S. national income since the beginning of the decade, nearly three-fourths of the 5.7 percent of national income that individuals and businesses together manage to save after spending for consumption and for the replacement of physical assets (like houses or machines) that wear out. As a result, U.S. investment in new business plant and equipment has fallen to a smaller share of national income than in any previous sustained period since World War II. So has investment in roads, bridges, airports, harbors, and other kinds of government-owned infra-structure. So has investment in education (even including spending by state and local governments), despite the urgent need to train a work force whose opportunities will arise more than ever before in technologically advanced industries. In short, we are not investing in any of the makings of a strong economy.

Some observers have argued that government deficits do not reduce business investment, pointing for example to Japan, where both the government's deficit and business investment are larger, compared to national income, than ours. Such comparisons miss the point. What matters is how much saving is left over after the government borrows what it needs to finance its deficit. If our saving rate were as high as Japan's, we too could afford an even larger government deficit and still have enough left over to do more investing. But America has always been a low-saving country, and the supposed saving incentives enacted early in the Reagan administration proved extremely disappointing. What is different in America in the 1980s is not that we are saving so much less than before, but that the government is absorbing so much more of what we do save.

With so little investment in the basic structure of a strong economy, it is not surprising that our industry's ability to produce goods and services has been disappointing in the 1980s. Worse still, U.S. productivity has flagged despite the fact that some of the other forces that typically affect business performance have improved. Workers on average are older and more experienced, business has spent more on research and development, most of the investment needed to meet environmental regulations is already in place, and energy prices have fallen. But the weakness of business investment has overwhelmed these favorable developments. There has been no significant increase during the 1980s in the amount of capital at the disposal of the average American worker. And in part for that reason, since 1979 (the last year of full employment before the two business recessions that began this decade) our overall productivity growth has averaged only 1.2 percent per year. If productivity growth continues at this pace, we shall, at best, be able to do no more than pay the interest on our mounting foreign debt, leaving no margin to provide for increases over time in our standard of living. The further need to devote some 3 percent of our national income merely to balancing our export-import accounts will therefore have to come out of incomes that are already stagnating.

A second, and perhaps even more worrisome cost of our current economic policy is that it has weakened America's position in the world order. The great sums we have borrowed to finance our overconsumption have included large amounts borrowed from abroad. With government borrowing absorbing nearly three-fourths of our private saving since 1980, heightened competition among business and individual borrowers for the remainder has raised our interest rates, compared to inflation, to record levels, well above what investors could get in other countries. For half a decade, therefore, the dollar became ever more expensive in relation to other countries' currencies, as foreign investors competed among themselves to acquire dollars with which to buy high-interest U.S. bonds and other dollar IOUs. As the dollar rose, the ability of our industries to compete with foreign producers all but collapsed, not only in world markets but here in America too.

With the dollar so overvalued, we therefore increased what we consumed faster than what we produced, not only because we failed to invest adequately in new productive capacity at home but because we increasingly used our overvalued dollars to import more than we exported. The $25 billion gap between U.S. exports and U.S. imports of merchandise trade in 1980, considered a major problem at the time, grew to $161 billion in 1987. As we paid for this growing excess of imports over exports, we sent more and more dollars abroad, and foreigners then invested these funds in our financial markets. Indeed, because so little of what Americans save is left over after the government has financed its deficit, this re-investment of our own dollars by foreign lenders now accounts for most of the inadequate supply of capital that American business has available for investment. In 1987 the total amount that American businesses invested in new plant and equipment was $447 billion, or merely $75 billion beyond the mere replacement of worn-out facilities. The net flow of investible funds into U.S. markets from abroad came to $161 billion.

As our trade deficit continued to grow, throughout the 1980s, the great accumulation of dollars in foreign hands increasingly saturated the foreign appetite for dollar-denominated assets. The waves of selling that drove the dollar down in 1986 and 1987 had to come sooner or later. By now, after the most recent rise, the dollar is about back to where it was in 1980. With the dollar cheap again, our trade deficit has begun to shrink. But a significant correction will take time, in large part because we have underinvested in our economy as a whole and especially in industries like manufacturing that compete against foreign producers. As recently as 1986, total U.S. investment in manufacturing was only 1 percent above what it had been in recession-depressed 1982. We are increasingly learning that a cheaper dollar by itself is not enough. Our industries must also have the capacity to produce enough of what people here and abroad want to buy.

Even more important, as a result of our excessive borrowing we have, within less than a decade, dissipated our net international holdings and run up the world's largest net debt -- $368 billion as of the end of 1987, and probably more like half a trillion by yearend 1988. Now, therefore, we have not one debt problem but two: the debt that our government owes as a result of borrowing to finance its string of record budget deficits, and the debt that we as a nation owe as a result of borrowing from abroad to finance our string of record trade deficits. Even on the most optimistic trajectory, our debt owed abroad (over and above what foreigners owe us) will continue to grow in relation to our income for several more years, until we reach a debt-to-income ratio comparable to that of many of today's hard-pressed developing countries. If we allow our net foreign debt to continue to grow at its current pace until the mid 1990s, for example, our debt-to-income ratio then will be roughly equal to what Brazil's is today.

One grave implication of America's becoming a debtor nation is simply our loss of control over our own economic policies. Losing control over one's affairs is, after all, what being in debt is all about -- no less for a nation than for an individual or a business. Foreign investors who may become nervous about holding U.S. bank deposits and U.S. Treasury securities, are perfectly free to buy up our businesses and our real estate instead. They are already doing so in increasing volume, and, given the vast amounts of dollars held abroad, it is clear that the process has only begun.

More important, world power and influence have historically accrued to creditor countries. It is not coincidental that America emerged as a world power simultaneously with our transition from a debtor nation, dependent on foreign capital for our initial industrialization, to a creditor supplying investment capital to the rest of the world. But we are now a debtor again, and our future role in world affairs is in question. Over time that role will gradually shift to Japan and Germany, or still other new creditor countries that are able to supply resources where we cannot, and America's influence over nations and events will ebb. Watching our economic power shift to these new creditors as they begin to cope with the developing world's debt, for example, or step in to prevent a "dollar crisis," in both cases presumably in ways that promote their own commercial or diplomatic advantage -- is merely the price we shall pay for the fiscal policy we have pursued throughout the 1980s.

Most Americans continue to think of themselves as creditors, and we readily offer unsolicited advice to other debtor countries, as if they had fallen into a trap that we had successfully avoided. Meanwhile, the Japanese and Germans still appear to think of themselves as debtors. But attitudes toward world leadership will change soon enough, as our financial problems circumscribe our scope for maneuver in world affairs while the new creditors' financial strength does the opposite. Just how large a departure from recent history the resulting new international arrangements will represent depends in part on whether, and how, we change our economic policy.

A New Budget Strategy

No change of policy, economic or other, can now neatly restore the damage done by the policy we have pursued in the 1980s. The assets we have dissipated are gone. The debts we have incurred are real. The full impact of these new economic facts has not yet reduced our living standards, because the excess of our consumption over our income that this policy has fostered is still under way. But this cannot go on forever, because the burdens of both our domestic and our foreign debts will continue to mount exponentially until, as many developing countries have found, no one is willing to hold either.

To limit the damage means, in the first place, not committing so much of our private saving, and foreign borrowing, to finance the federal deficit. Even so, there is nothing magic balancing the budget. There are times when either a deficit or a surplus is more appropriate to the nation's economic needs. Moreover, simply matching government income and expenditure makes even less sense when accounts are as crudely and arbitrarily measured as the U.S. government's. There is no reason to think that the many mismeasurements and outright omissions that are by now so familiar simply offset one another.

The best measure of a government's fiscal position, over long periods, is whether its debt is rising or falling compared to national income -- that is, the total value of the all goods and services that the country produces. Throughout two centuries of America's peacetime experience -- until the 1980s -- our federal debt was almost always declining in relation to our national income. The ratio of federal debt to income rose, sometimes sharply, in each of the wars we have fought. But once each war ended, we returned to repaying that debt, if not through outright budget surpluses then at least in the economic sense that, if the debt rose at all, it rose less rapidly than income. The only exception -- again, until the 1980s -- was in the early 1930s, at the bottom of the depression.

The guiding aim of American fiscal policy in the aftermath of the Reagan years should be to restore the federal debt to a declining trajectory compared to the nation's income -- and to do so without inflation. A declining ratio of debt to income will mark a return to the traditional U.S. fiscal posture. The 1980s will then have been a highly costly, one-time aberration. The nation will no longer be following a policy that is obviously unstable in the long run, and that is currently imposing a growing mortgage against future American living standards.

A sensible and cautious strategy for the next eight years should aim to reduce the debt ratio at about half the pace at which it has risen between 1980 and 1988, so that by 1996 the federal debt will then be no more than 34 cents for every dollar of our income. Because incomes will continue to grow in real terms, and because there will inevitably be some modest inflation, meeting this target does not mean eliminating budget deficits altogether. But it does mean bringing federal revenues and expenditures closer into line -- much closer into line -- than under President Reagan. If growth of national income during this period continues to average 2.5 percent per annum after inflation (as during 1980-88), while inflation runs at 3.3 percent per annum (the average since our unacceptably high inflation ended in 1982), total annual income will reach approximately $7.7 trillion by 1996. Debt equal to 34 cents per dollar of income would amount to approximately $2.6 trillion at yearend 1996, compared to debt outstanding (not counting what the government owed to itself) of some $2.1

trillion as of yearend 1988. This means limiting the growth of the federal debt to $500 billion over eight years, and the average annual budget deficit in those years to approximately $60 billion, right at $100 billion per year less than the deficit projected by the Administration for the current fiscal year.

Moreover, in estimating these magnitudes we should not take into account the surpluses -- almost $60 billion this year, more like $70 billion next year, and still larger in the 1990s -- currently accruing in the Social Security trust fund. To do so would defeat the purpose for which Social Security contribution rates were raised in 1983, namely to enable the Social Security System to cope with the burdens it will face early in the next century. The aging of the postwar baby boom generation will sharply raise the number of retirees receiving benefits compared to the number of workers making contributions. Without these surpluses now, there will be no choice but to raise payroll taxes for that era's workers to unacceptably high levels, or reduce benefits sharply -- just the outcomes that the 1983 legislation was intended to avoid. The target of $2.6 trillion of federal debt outstanding as of yearend 1996 should therefore include whatever amount of federal debt the Social Security fund may accumulate, and the target $60 billion average annual deficit during 1989-96 should include whatever part of each year's deficit the Social Security surplus may appear on paper to offset.

Getting from Here to There

What is necessary, therefore, is to narrow the deficit by roughly $150 billion from its currently projected level of approximately $210 billion (without the Social Security surplus). Achieving this objective will require three steps.

First, we will need substantial cuts in government spending. Smoke-and-mirrors accounting gimmicks will not do. Neither will sales of government-owned assets, which absorb private saving just like sales of Treasury bills. Making genuine progress in narrowing the deficit means making genuine cuts in federal programs. The notion that there are no possible areas in which to make these cuts is simply wrong. The Congressional Budget Office's "Reducing the Deficit: Spending and Revenue Options," issued just this month, lists over a hundred possibilities, ranging from the tiny to the huge. What may be impossible, however, is finding enough of them that were not ruled out -- presumably as a matter of political necessity -- during last fall's election campaign. Rhetoric about needless government programs notwithstanding, three fourths of all federal spending now goes for defense, Social Security, Medicare and Medicaid, and interest on the national debt. And the remaining one fourth includes such items as federal law enforcement, the courts, drug enforcement, our embassies abroad, the immigration authority, tax collection, highway construction, the space program, the national parks, disaster relief, public health, public housing, veterans' benefits, federal civilian and military retirement pensions, and child nutrition.

The relevant question is not whether it is possible to identify further potential reductions in non-defense spending, or economies in providing for our defense. There is no lack of possibilities. The real question is whether Americans actually want to implement these potential cuts, in sufficient magnitude to bring total government spending into line with total government revenues. The standard political rhetoric of the 1980s has repeatedly asserted that a consensus for such cuts exists. But the experience of the 1980s -- including the fact that President Reagan's total spending requests came so close to the total spending actually voted by Congress -- suggests that it does not.

Second, therefore, we will also need a tax increase. From a purely economic perspective, it makes little difference whether we solve the budget problem by cutting spending or by raising taxes. But a key lesson of the past eight years is that we are unlikely to solve the problem at all if we limit our attention to spending cuts only. Raising taxes would, of course, violate one of President Bush's campaign promises. But then so would cutting federal spending by enough to solve the problem without a tax hike.

If we make enough spending cuts, we may be able to do the rest of what we need with such "revenue enhancements" as higher taxes on gasoline, tobacco and alcohol, and higher user fees for services that the government provides. Otherwise, solving the problem will require either an increase in income tax rates or the introduction of some new kind of tax. A consumption tax would be preferable, for reasons of economic efficiency and incentives. So would a European-style value added tax, which is like a national sales tax. But if nobody has the will to reopen the debate about what form of tax structure America should have, it is worth remembering that merely raising the two benchmark rates in our current income tax from 15% and 28% today to 18% and 31%, respectively, would generate $75 billion per year of additional revenue, on average over 1989-96 -- fully half of the deficit narrowing that we need.

By contrast, President Bush has suggested that a "flexible freeze" on federal spending -- specifically, restraining growth of all federal spending, other than the Social Security program, to no more than the rate of inflation -- can do the job without requiring additional revenues. Wholly apart from the important question of whether the economic assumptions underlying this claim are overly optimistic (an issue that has already received substantial national attention), the very concept of the flexible freeze, as President Bush has described it, is questionable in several key respects.

For example, what if interest rates remain at their current levels (or go higher), instead of falling substantially as the administration predicts? Some descriptions of the flexible freeze have included the interest paid on the national debt as part of "all federal spending other than Social Security," so that sticking to the flexible freeze would then mean having to enact (perhaps even after the fact) some billions of dollars of additional cuts in non-interest spending, so as to offset the larger interest payments. Other descriptions of the flexible freeze have excluded interest from the catch-all of spending to be limited, so that the success of the flexible freeze in achieving its stated objective will depend crucially on whether the forecast of declining interest rates proves accurate.

As another example, what if resolving the growing distress in the savings and loan industry requires more than the relatively small amounts called for by the administration's new rescue plan? If this spending is "on budget," then, once again, sticking to the flexible freeze would mean finding an equal amount of additional cuts, beyond those initially proposed, in other spending programs. If it is "off budget," then the flexible freeze might be successful in some technical sense, but the sales of government debt -- in this case the debt of some specialized agency, rather than of the Treasury directly -- would continue to absorb our private saving anyway.

For this reason -- including not just these two obvious examples, but many others besides -- the "flexible freeze" is not likely to be successful. Confronted in the future by its lack of success, the current advocates of this strategy will no doubt say that it never worked because it was never tried. And, in a technical sense, they will be right. But the reason why the flexible freeze will not have been tried, in that sense, is that it is itself so unworkable. I therefore believe that righting the government's fiscal imbalance, under today's circumstances, will instead require some combination of actions involving both spending restraint and increased revenues.

Finally, we will also need an easier monetary policy -- but only _if_ we cut spending enough and raise taxes enough to make real progress in narrowing the deficit. Nobody wants a recession, and it is possible (though far from certain) that a major tightening of fiscal policy would have just that effect if the Federal Reserve did not offset the reduced stimulus to total spending by lowering interest rates. After all, there is nothing wrong with our level of economic activity overall. The problem is that there is too much consumption and too little investment, too many imports and too few exports. The best way to correct those imbalances without risking a recession is to shift our policy mix, matching a tighter fiscal policy with an easier monetary policy.

The economic policy that we have pursued in the 1980s -- a policy based on large tax cuts not matched by spending cuts -- has produced record budget deficits despite peace and full employment, and a national debt that is rising compared to national income. As a result, our investment in domestic capital has been eroded, and for a while our international competitiveness all but collapsed. Without economic growth, American society will ultimately lose its dynamic sense of progress, its capacity to accommodate the aims of diverse groups within the population, its ability to offer the remarkable social mobility and individual opportunity that is its hallmark. Without a strong and competitive economy, America as a nation will watch others take its place in the world order. These are the real costs of our current fiscal policy. The fact that they are occurring gradually over time, rather than in some readily visible market collapse, does not make them any the less real or the less disturbing. It is time for a change.

* * *

Mr. Chairman, thank you for the opportunity to present my views to the committee.

Chairman **Sasser**. We will turn now to Dr. Jones.

STATEMENT OF DR. DAVID M. JONES, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, AUBREY G. LANSTON & CO., INC.

Dr. **Jones**. Thank you very much. One of the strongest impressions I would like to leave with the committee today is the sense of how the financial markets are responding virtually to every "i" you dot on this committee and "t" you cross. I was struck most——

Chairman **Sasser**. A frightening thought.

Dr. **Jones**. A frightening thought.

I was struck most importantly by this with a trip to Europe, actually during the time when the budget summit was being held in November 1987. I had developed a bit of cynicism about how much of a reduction that we could have in that 2-year budgeting process for fiscal years 1988 and 1989.

But by the time I got to Germany in this case, I was absolutely amazed at how much interest and focus on the budget negotiations at that time that were taking place. They literally were ahead of me in terms of seeing what was happening in terms of potential revenue increases and potential spending cuts in those budget negotiations.

In a sense, the interest in world financial markets, if anything, has become greater since that time, and what I want to leave with you today, perhaps more than anything else, is that the financial markets are critically interested in what I guess I would have to call actions that would lead to permanent budget deficit reductions.

In this respect, I would like to touch on three things that perhaps are somewhat troubling. And, by the way, my focus of attention in analyzing the financial markets is primarily the dollar on the foreign exchange markets and the Government securities market.

First of all, the combination of the existing budget deficit we are looking at, estimated at roughly $170 billion in fiscal year 1989, and looking ahead to 1990, the Bush budget have shaken the markets a bit. The dollar fell a bit around the time of the announcement of the Bush budget message perhaps largely because of the fact there was no clear-cut economic agenda in that Bush budget message. It is a bit fuzzy. One cannot tell whether the new President wants to put off a tax increase until perhaps 1990, when you might summarily reject it because of congressional election year considerations, perhaps, or whether there will be other kinds of future developments.

But the simple fact is this: What the markets are looking for is evidence of either a credible action on the revenue side—a gasoline tax increase would be an example—or concrete and credible actions in cutting spending, whether it is in terms of limiting escalators on Social Security increases, which I know is a very touchy political issue, or any other major spending cuts.

I would emphasize that the financial markets, at least at this moment, are looking more in the direction of that kind of action that is highly visible and credible as opposed to simply playing the numbers game as to how much your estimates for fiscal year 1990 can be reduced. In no way do I want to suggest that that is not important, but it is a bigger order of priorities in terms of market thinking, at least, with respect to whether or not credible actions can be taken in a way that permanently will reduce the budget deficit.

Let me simply add that there is one other source of major concern, looking at things from a financial market perspective, and those are the inconsistent economic assumptions in the Bush budget. For 1990, it is estimated that real GNP growth—of course, our broadest measure of economic activity—will grow at 3.2 percent, while at the same time we will have a sharp reduction in short-term interest rates. I believe the 3-month Treasury bill rate is estimated at around 5.5 percent in 1990, down from about 8.5 percent right now, a full 3 percentage point decline.

That inconsistency hurts budget credibility in the eyes of the financial markets, and that is one of the reasons why we have seen a tendency for the dollar to become a little weaker as we discuss these budget messages. There is sort of a lack of confidence in the plan. This is also seen in the fact that the unsettling budget matters cause the long-term yield on Treasury bonds to move a little higher. So, in general, it is this series of events which is concerning the market: a lack of a specific policy agenda, a lack of credible actions, either on the revenue side or on the spending side, and some inconsistent economic assumptions.

Let me move on to some of the other key points I am raising in my testimony. I will be happy to answer any questions that you may have on the twin deficit legacy of the Reagan administration. I will simply underscore, as a second major point in my analysis, the fact that that deficit legacy, both the combination of large budget deficits and trade deficits, in the final analysis is causing us to lose control of our economic destiny. In some sense, as we lead from a budget deficit to a trade deficit and rely increasingly on the world to finance our affairs in this country, we are going to be subject as a country, increasingly, to financial volatility–whether it comes in a sharp dollar decline or a sharp long-term interest rate increase due to financial shocks, or whether it comes from another source that we might not recognize. The simple fact is that in a country where we thought we had control of our destiny, we now stand uncertain of our fate as a major debtor nation. To be sure, it is difficult to measure the dimensions of that indebtedness. But as a debtor nation, we are losing control of our economic destiny.

Let me move on also to something that Dr. Friedman, as a third point to make in my summary, hit on, and I would like to emphasize again. Our problem right now is, in essence, a gross imbalance between our available domestic savings and our investment requirements. I would simply cite in terms of my own statistics the fact that our national savings rate—that includes both the savings of consumers and business—and the dissavings of the Government has fallen by 1987, the latest statistics I have worked up on this, to 1.8 percent of GNP, down from 5.7 in 1981.

That drop in domestic savings, our net national savings rate, is very detrimental, as Dr. Friedman suggested.

Chairman SASSER. Would you repeat those, Dr. Jones?

Dr. JONES. Yes. Our net national savings rate—that consists of consumer and business savings—plus Government dissavings in the case of a deficit, has fallen in 1987 to 1.8 percent of GNP from 5.7 percent of GNP in 1981. An extremely disturbing trend.

In the meantime, our net national investment, again expressed in terms of GNP, as of 1987 fell to 5.1 percent from 5.5 percent, suggesting that perhaps we are being hurt in terms of our investment process and our need to increase productivity by this lack of domestic savings.

The fact that we in 1987, therefore, had to finance 5.1 percent national investment with only 1.8 percent national savings means, of course, we rely on the foreign sector to the tune of the difference, or 3.4 percent of GNP in 1987 versus actually some net lending abroad of approximately .2 percent in 1981.

In a fundamental way, this is the essence of our problem today. And as long as that imbalance persists, we will increasingly lose control of our destiny because foreign investors will be, in essence, through market developments calling the shots. If you do not do enough on the budget, you will see the dollar fall or long-term interest rates go up, and that imbalance is critical. There are only, as Dr. Friedman suggests, two ways to settle that issue immediately. Either we sharply increase the national savings rate—and I was extremely disturbed by Dr. Friedman's testimony that Harvard did not have an answer as to why the Japanese save more than Americans. And I certainly do not want to discuss my family in this regard, either my wife or my daughter. That is a touchy subject. At one time my wife was in the audience when I went into the discussion of whether the Jones family saves anything or not. I do not want to get into that today.

But, in general, the problem is either you increase the domestic savings rate or you reduce the budget deficit as a way to get out of this dilemma.

Finally, I would like to——

Chairman **Sasser**. What is the breakout on the private savings as opposed to the Government dissavings in your equation?

Dr. **Jones**. Net private savings, that is consumer plus business—I included the two together—for that same time period, 1987, is 5.3 percent versus 7.8 percent in 1981. So we have had in the private savings as a percent of GNP a dramatic decline.

By the way, that is mostly in the consumer, if you break down the numbers. The business savings ratio in relation to the economy is about unchanged from——

Senator **Fowler**. It is basically credit card debt.

Dr. **Jones**. That is, in essence, what we are talking about in that number. So the private sector savings was an important factor in this decline, as well as the increased Government borrowing as a percent of GNP, which rose to 3.4 percent in 1987 from 2.1 percent in 1981.

Let me just finish, if I might, in my summary with respect to another source of concern I have looking ahead. I think there could be, as the year goes on, an increasingly sharp possibility of a conflict between Federal Reserve policy and the administration's progrowth Government goals. We had some testimony by Fed Chairman Greenspan yesterday suggesting in no uncertain terms that he intends to rein in growth in order to limit the extent to which inflation is accelerating. And I imagine the good Fed chairman was not too happy with the news this morning that consumer prices shot up in January at a .6 percent increase or, roughly speaking, in round terms a 7.2 percent annual rate. I think it was the biggest monthly consumer price increase in 2 years. We also had, of course, a huge producer price increase of 1 percent or a 12 percent simple annual rate in January.

My feeling is that the Fed will increasingly attempt to rein growth down below 3 percent in order to limit inflation increases. Therefore, the Fed will be pushing rates up to do that, at the same time the administration is postulating growth well above 3 percent in order to generate enough revenue to reduce the budget deficit without a tax increase. I think this potentially could be a fundamental conflict in objectives as we look ahead toward the end of the year.

So let me wind up with this point. My concern is—and, again, it is a market concern—that as we go through this process of attempting to reduce the deficit, that we are constantly seeing increasing volatility in the financial markets, either vulnerability in the dollar because of concern about the lack of credible actions, or, indeed, a clash between the Fed and the Bush Administration in terms of the potential for increases in interest rates. We do not want either one of those results. Therefore, I think your deliberations will be critical to an outcome here as to whether or not we can fundamentally reduce that budget deficit and regain control of our economic destiny.

Thank you very much.

Chairman SASSER. Thank you very much, Dr. Jones.

[The prepared statement of Dr. Jones follows:]

PREPARED STATEMENT OF DR. DAVID M. JONES, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, AUBREY G. LANSTON & CO., INC.

In analyzing the impact of the current deficit on the economy, I would like to focus on four major areas: the Financial market's response to both the current deficit and the prospective Bush 1990 budget; the "twin budget and trade deficits legacy of Reagan Economics; the current gross imbalance between inadequate U.S. domestic savings and the need to increase both private and public investment in order to stimulate lagging productivity; and the possibility of a policy clash between the Federal Reserve and the Bush Administration. The Bush Administration got off to a good start in expressing a desire for close cooperation rather than confrontation with Congress in the important task of concluding successful budget negotiations. However, there is presently the threat of some fragmentation in the Bush effort on competing issues such as the North Trial, the unresolved Tower nomination, and a surprise Central American peace initiative compete for attention. My primary purpose today is to underscore the need for continued progress towards a new era of fiscal discipline.

FINANCIAL MARKET RESPONSE

As a sounding board for the implications of both current and prospective budget deficits, it is instructive to examine the collective judgment of large numbers of buyers and sellers in the domestic and foreign financial markets; special emphasis should be placed on the dollar and the market for U.S. Government securities. It is noteworthy, for example, that the U.S. dollar declined in the foreign exchange markets both just before the Bush budget message (when most of its elements had already been leaked), and just after the budget message itself. Apparently, foreign investors, who have been financing an important share of our deficit, were signaling disappointment over a lack of credible measures to either increase revenues, or reduce spending, at least in terms of a permanent deficit-cutting impact. Moreover, around the time of the President's February 9 budget message, the Treasury's regular quarterly refunding operation involving the issuance of a total of $28.75 billion in 3-year, 10-year and 30-year notes and bonds was poorly received by both foreign and domestic investors. While perceptions of a lack of Bush deficit-cutting credibility was by no means the only negative influence on the dollar or the U.S. Government securities market at this time, this factor was at least an important market consideration.

At its roots, the collective skittishness in the financial markets may hinge in part on the fact that the Bush Administration seems to have no clear-cut policy agenda. It almost seems, for example, as if President Bush wishes to put off hard tax-increase decisions until say sometime in 1990; but Congress might well reject such a delayed tax increase proposal owing to Congressional election-year concerns. To be sure, the Bush Administration has skillfully initiated the budget negotiation process with Congress; there is every reason to expect conciliation and cooperation in contrast with the confrontational approach so often practiced by the preceding Reagan Administration. Indeed, the Bush Administration may actually be intent on working in a closer partnership than Congress might want, especially in the areas where the blame might be shared for distasteful cuts in some social programs.

But the fact remains that while the Bush 1990 budget message may have been presented with style and negotiating flair, it is short on substance. And to make matters worse, the Bush budget rests on the shaky foundation of inconsistent underling economic assumptions. Specifically, real GNP growth is postulated at a strong and potentially inflationary (particularly in current conditions of high resource utilization) pace of 3.2 percent next year. Yet, incredibly, this brisk economic growth is, in turn, asumed to somehow bring about a sharp decline in the 3-month Treasury Bill rate to 5.3 percent in 1990 (compared with a current level of about 8.5 percent).

BUSH BUDGET

The Bush budget for fiscal year 1990 aims at an unrealistically low estimated deficit of $94.8 billion, conveniently below the statutory Gramm-Rudman-Hollings ceiling of $100 billion, and far below the estimated $170 billion deficit in 1989. On the social (nondefense) spending side, the tone of the February 9 budget message revealed a "kinder and gentler" Bush approach. In a major departure from the toughter-minded Reagan Administration in these nondefense areas, Bush announced new program efforts in education, health care, child care, pollution control, and drug prevention. While these all may be worthy social spending initiations, they threaten to open the flood gates of social spending, especially in future years.

The Bush defense spending proposals also convey a lack of fiscal discipline. Specifically, Bush is proposing to limit the increase in defense outlays to the rate of inflation in fiscal 1990 (no increase in real defense spending). But then the Bush Administration proposes to increase defense outlays at a rate 1 percent faster than inflation in fiscal years 1991 and 1992 (a 1-percent increase in real defense spending per year). Subsequently, in fiscal 1993, it is proposed that defense spending be increased at a still faster pace of 2 percent in excess of inflation (representing a 2-percent increase in real defense spending).

Also smacking of a lack of fiscal discipline is the fact that on the revenue side, the only major Bush initiative was a proposed reduction in the capital gains tax to 15 percent from the current top tax rate of 33 percent (same as income). Although subject to debate, this reduction in the capital gains tax would seem likely to produce less rather than more revenue. Other tax breaks for urban enterprise zones and other purposes, though appropriately aimed at increasing productive investments, would also seem more likely to reduce revenue in fiscal 1990 rather than increase it.

In the meantime, the Bush Administration apparently hopes to hold a series of high level budget meetings with Congress similar to Budget Summit between the White House and Congress, triggered by the October 1987 stock market crash. At this earlier November 1987 Summit there was, most appropriately, agreement on budgeting for a two-year rather than a one-year period. Specifically, the 1987 Budget Summit sought to impose special deficit cutting measures on both fiscal years 1988 and 1989. However, foreign and domestic investors alike were concerned, in the end, over the lack of either any major revenue enhancement measures (such as a gasoline or consumer tax increase) or tough spending limits on entitlement programs (such as limits on cost-of-living-escalators on Social Security). Reflecting this lack of fiscal discipline, the unified budget deficit jumped to an estimated $170 billion in fiscal 1989, up from $155 billion in 1988, and far above about the 1989 G-R-H statutory limit of $136 billion. Without further major spending or tax initiatives, the Bush budget could be destined to meet the same fate—that is, it may produce an actual deficit for 1990 that far exceeds the G-R-H guidelines.

"TWIN" DEFICIT LEGACY

The legacy of the Reagan Administration is mixed. On the positive side, of course, there is a peacetime economic expansion of unprecedented length (6¼ years), and, at least until quite recently, generally declining price pressures and interest rates. Striking a less favorable chord, however, are the Reagan legacies of hugh "twin" budget and trade deficits, along with a fundamental imbalance between inadequate domestic savings and the need to increase private and public investment in order to stimulate lagging productivity.

It is important to take a closer look at how the budget and trade deficits came to exist side by side in the Reagan Administration. In essence, President Reagan had a simple fiscal policy agenda. He wanted to get the Federal government "off the backs" of middle and upper income taxpayers (his main constituents). To accomplish this, President Reagan sought huge tax cuts apparently aimed at pulling Federal revenue below a threshhold of 20 percent of GNP. In addition, on the spending side, President Reagan sought to both increase defense spending sharply, while, at the same time, forcing Congress to cut nondefense spending sufficiently to balance the budget by no later than 1984. The rest, as they say, is history. Suffice it to say that by fiscal 1985 success had been achieved on the revenue side as revenues fell to 18.5 percent of GNP; but disaster struck on the spending side as Federal outlays (defense and nondefense) climbed to about 25 percent of GNP. Accordingly, the fiscal 1985 budget deficit rose to about 5.4 percent of GNP or nearly four times the level prevailing in the early 1960's.

The unique feature of this Reagan fiscal stimulus was, however, that it was mismatched, especially in 1983 and 1984, with monetary restraint. This set off a causal chain leading to a large trade deficit, a chain which unfolded as follows: the clash between fiscal stimulus and monetary restraint produced high real interest rates (nominal rates less inflationary expectations); this upward pressure on real rates was heightened by inadequate domestic savings. The relatively high U.S. real rates led to a dramatic strengthening in the U.S. dollar as foreign savers sought U.S. investments carrying these attractive returns. The strong dollar in turn, led to a huge trade deficit as U.S. exports became more expensive and U.S. imports became less expensive. The disturbing implication of this chain reaction, especially during 1985 and 1986, was that foreign competition threatened eventually to depress U.S. manufacturing and agricultural activity to a point that would stop the U.S. expansion in its tracks.

However, to counter these weakening tendencies, the U.S. monetary authorities eased their policy stance and pushed interest rates lower in 1985 and 1986, and again following the stock market crash in late 1987. This monetary stimulus, in combination with official central bank efforts to push the dollar lower, resulted in a sharp dollar decline and a falling trade deficit (especially in late 1987 and 1988), as exports grew less expensive and imports became somewhat more expensive.

The problem as 1989 begins is that progress in reducing the trade deficit seems to be stalling as export industries bump against capacity limits and imports remain excessively high, owing, particularly to seemingly unstoppable upward momentum in consumer spending. Of course, the counterpart to excessive consumer spending in this expansion is inadequate domestic savings. As can be seen in the table below, net private savings (consumer and business) fell to 5.3 percent of GNP in 1987 from 7.8 percent in 1981. But, just the same, there is the need to finance a 1987 federal deficit that represented 3.4 percent of GNP (even though down from the much higher 5.0 to 5.5 percent share of GNP of the 1985-1986 period). The upshot is that there is an inadequate domestic savings pool to finance both the Federal government's deficit (dissavings) together with much needed investment in new plant and equipment.

U.S. SAVINGS AND INVESTMENT

[As a percentage of GNP]

	Net private savings	Net government dissavings	Net national savings	Net national investment	Net foreign investment
1981	7.8	−2.1	5.7	5.5	−.2
1987	5.3	−3.4	1.8	5.1	3.4

The harsh reality is that unless we dramatically cut the federal deficit, or substantially increase domestic private savings, we have to rely increasingly on foreign investors to finance the investment required to stimulate lagging productivity. However, starting in 1987 private foreign investors began to pull back from dollar investments, forcing central banks to engage in massive direct dollar support. Indeed, these official institutions came close to fully financing the U.S. current account deficit in 1987. This dependence on uncertain foreign investment sources, always threatens increased volatility in the dollar (especially on the downside) and interest rates (especially on the upside). It goes without saying that the stock market also suffered from the dollar confidence problems in 1987.

FEDERAL RESERVE POLICY

A major clash betweeen Federal Reserve anti-inflation policies and Bush Administration pro-growth policies is brewing. Since mid December 1988, the monetary authorities have tightened money market pressures in three modest steps, pushing the Federal funds rate (the rate on reserve balances at the Fed that are loaned and borrowed among banks, usually overnight) up to a present level of about 9¼ percent from 8½ percent. Previously, Fed tightening moves during the year 1988, including an early August discount rate increase, had pushed the funds rate to the December level of 8½ percent from approximately 6½ percent at the beginning of last year.

The problem Fed policymakers face is that these cumulative tightening steps have not, as yet, had the desired moderating impact on economic growth. Indeed, real GNP growth continues to exceed the trend in longer-term U.S. potential growth (about 2.7 percent per year) at a time of high resource utilization rates. This excessive growth at a time of mounting strains on productive capacity has triggered, not totally surprisingly, recent disturbing signs of accelerating wage and price pressures.

The upshot is that Fed policymakers are likely to continue to tighten money market conditions gradually over the months ahead. To be sure, each of these Fed tightening steps are likely to be modest and carefully defined in deference to their negative impact on the pressing and severe savings and loan problems and the still monumental Third-World debt difficulties. Indeed, at present, the Fed could be perceived as, if anything, underreacting to signals of accelerating monetary inflationary pressures, as most recently seen in the January explosion in produce prices. Nevertheless, the independent monetary authorities are unlikely to give into Bush Administration desires to continue to maintain rapid economic growth in order to generate sufficient revenue to reduce the budget deficit without increasing taxes. In essence, restraint-minded Fed policymakers currently see no margin of error on the upside, in terms of economic growth, at a time of high labor and capital utilization.

CONCLUSION

The current and future Federal budget deficits have important implications for U.S. economic activity. The danger is that the Bush Administration will put off too long the hard tax increase and spending-cut decisions required to convince domestic and foreign investors alike that permanent deficit relief is in sight. This delay would put an unreasonable burden on the Federal Reserve to tighten policy sufficiently to curtail inflation while at the same time slowing domestic demand and import growth.

As a nation, our basic problem is that our domestic savings are inadequate to finance both federal deficits (holding stubbornly at about 3 percent of GNP) and increased private investment required to stimulate lagging productivity. Our only policy alternatives are to sharply reduce the federal deficit, dramatically increase domestic savings, or to rely increasingly on uncertain sources of foreign investment.

The problem with choosing the latter course of action is that private foreign investors may again, at any time, attempt to diversify into stronger foreign currencies as they did in 1987. The result would likely be periods of undesirably pronounced downward pressures on the dollar and pronounced upward pressures on U.S. interest rates.

In that event, the downward pressure on the dollar and the upward pressure on U.S. interest rates could become so severe that U.S. investment in new plant and equipment as well as housing activity would be severely curtailed and the U.S. economy could be pushed into recession. The point is that the longer the Bush Administration (and Congress) avoid hard choices in cutting the federal deficit, the more vulnerable our economy becomes to financial shocks, and the more likely we will be to lose control of our own economic destiny.

TABLE I.—BUDGET DEFICITS AND G-R-H [1] GUIDELINES

[Amounts in billions of dollars]

Fiscal year	Deficit	Percentage of GNP	G-R-H [1] guidelines	
			Old	New
1984	185	5.0		
1985	212	5.4		
1986	221	5.3	172	
1987	150	3.4	144	
1988	155	3.2	108	144
1989	[2] 170	3.4	72	136
1990	[2] 150	2.8	36	100

[1] Gramm-Rudman-Hollings deficit-cutting law, originally passed December 1985, and subsequently modified in September 1987.

[2] A.G.L. estimate.

CHART I

EFFECTIVE FED FUNDS RATE and
30 YEAR BOND YIELD
January, 1978 to January, 1989

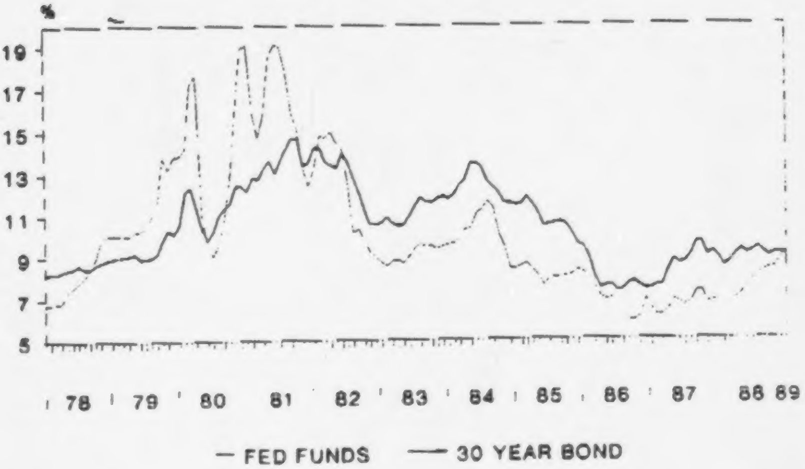


CHART II

EMPLOYMENT COST INDEX
2nd Quarter, 1982 to 4th Quarter, 1988

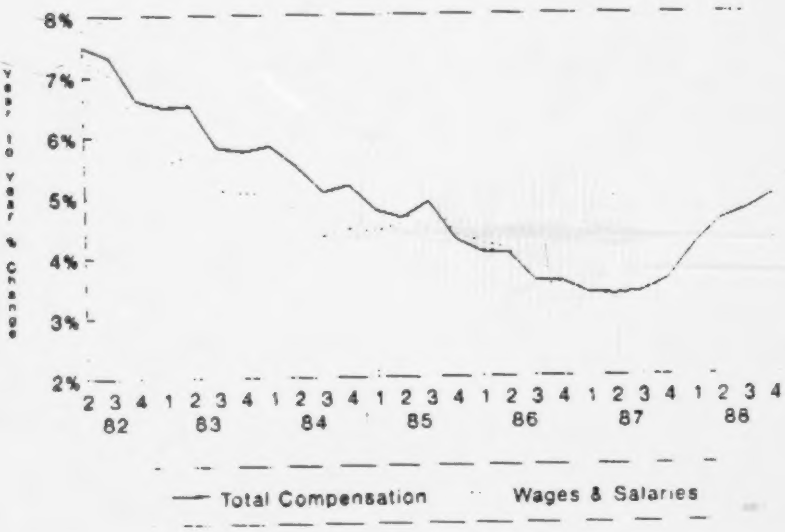


CHART III

CIVILIAN UNEMPLOYMENT RATE
(MONTHLY 1970-1988)

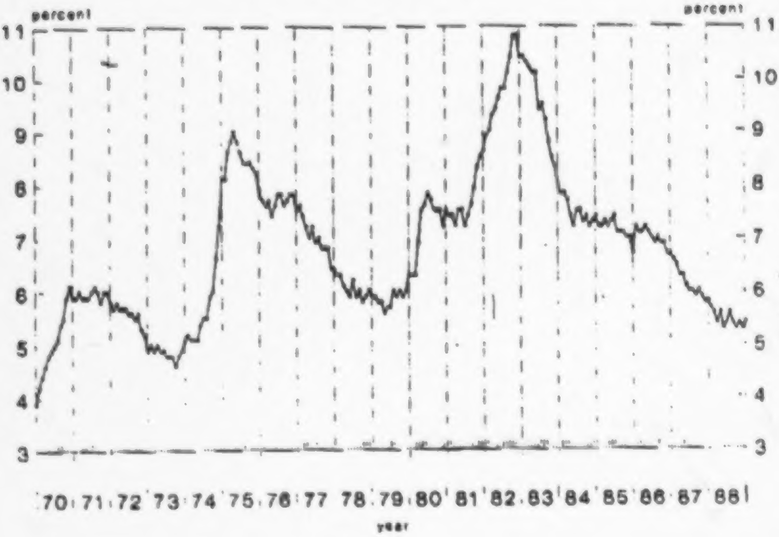


CHART IV

INDUSTRIAL CAPACITY UTILIZATION RATE
(MONTHLY 1970 - 1988)

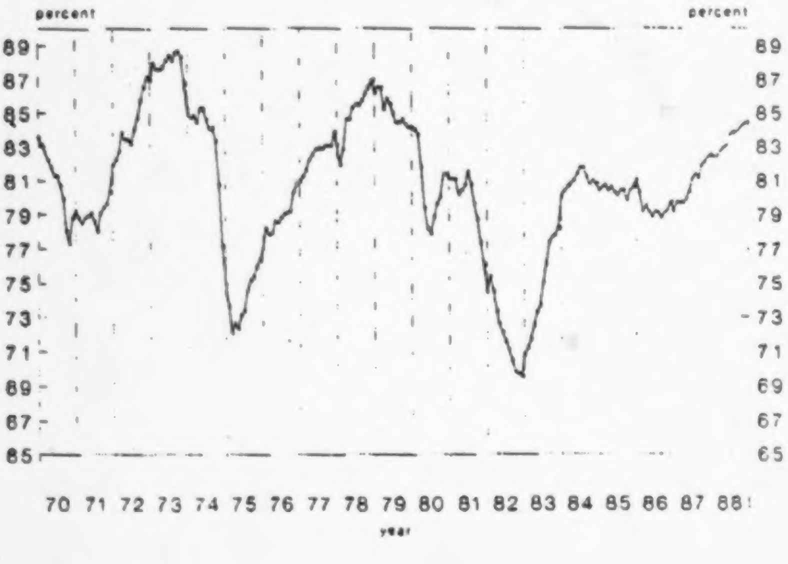


CHART V

EXPORTS AND IMPORTS OF GOODS & SERVICES

(QUARTERLY 1979 - 1988)

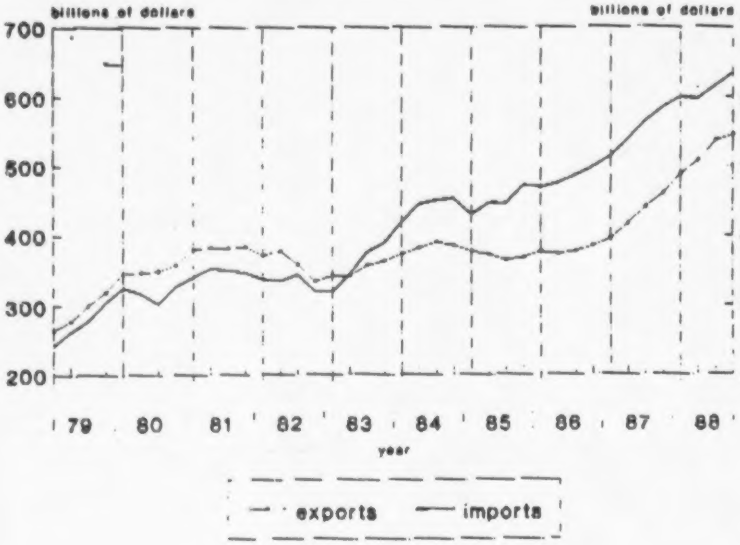


CHART VI

YEN EXCHANGE RATE

(MONTHLY 1970 - 1989)

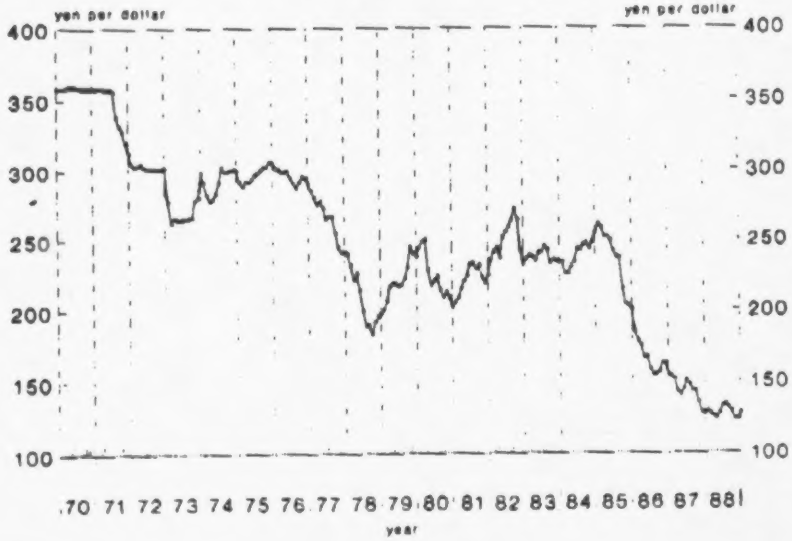


CHART VII

SELECTED LONG-TERM INTEREST RATES

(MONTHLY 1978 - 1988)

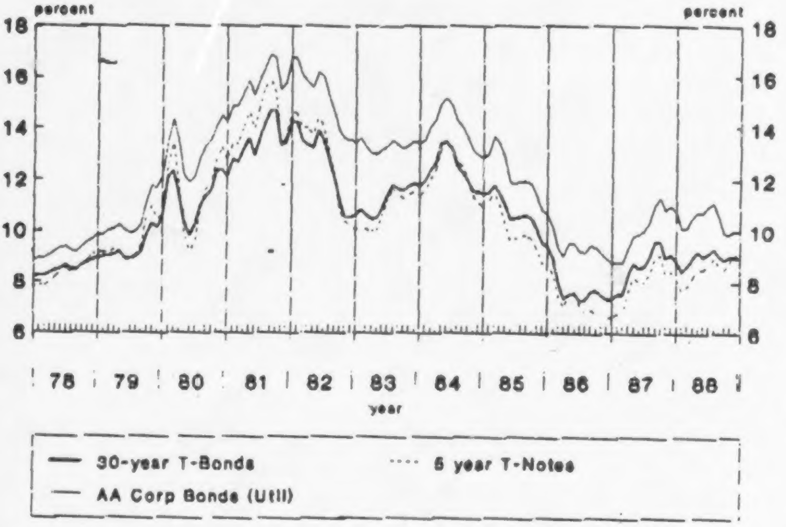
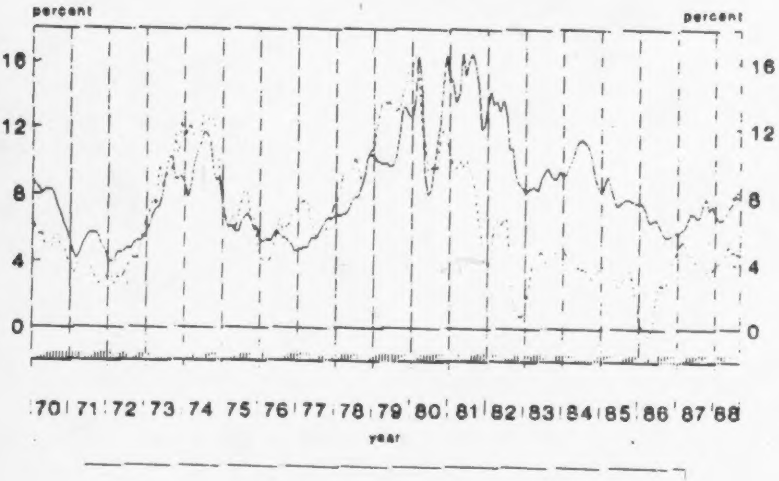


CHART VIII

REAL INTEREST RATE: 6 MO COMMERCIAL RATE - CPI % CHANGE OVER 6 MONTHS



Chairman SASSER. Dr. Wolf, we are going to turn to you now and let you have the last word before we turn to the Senators for their questions. I suspect you might have some areas of disagreement with our two previous witnesses. So you may proceed sir.

STATEMENT OF DR. CHARLES WOLF, JR., DEAN, RAND GRADUATE SCHOOL

Dr. WOLF. Thank you, Mr. Chairman and Senators. It is a privilege and a pleasure for me to appear this morning before your committee and to share with you my views on the twin deficits, which happily do differ somewhat from the views expressed by my colleagues.

I would like to ask the committee's indulgence if I read this statement. It is considerably briefer than those of my two colleagues, and I think parts of it may be a little bit dense. Perhaps the density will gain in clarity if I read it and interpolate some explanatory comments and emphasis along the way.

Chairman SASSER. Please feel free to read it, Dr. Wolf.

Dr. WOLF. Thank you, sir. I have perhaps immodestly titled these remarks "A Proper Perspective on the Twin Deficits," to suggest that most expressions of perspectives on the deficits are not, in my view, accurate.

While it is true that the deficit twins, the budget and the trade deficits, are important, the degree of concern currently expressed about them seems to me greatly exaggerated. Failure to reduce, let along eliminate, them may be imprudent. It would not be a disaster.

Moreover, focusing on the deficits diverts attention from the economy's more significant longer-run problem; namely, the aggregate savings rate, which Dr. Jones and Dr. Friedman have, indeed, stressed in their remarks.

Were the deficit problems to be eased while the savings rate remained low, our economic prospects would be bleak. On the other hand, if the savings rate were raised by 2 or 3 percent of the GNP, the longer-term economic outlook for the United States would be sanguine whether or not the deficits remain.

To help focus on what is primary and what is secondary, I think it is worth recalling a few fundamentals about the deficit twins, the relation between them, and their consanguine parentage. The trade deficit, or, to be more accurate, the current account deficit, is identically equal to the difference between savings and investment. In an accounting sense, the amount by which investment exceeds savings is exactly equal to the amount by which imports of goods and services exceeds exports.

In the past decade, the aggregate U.S. savings rate has declined by about 3 or 4 percent, from about 16 or 17 percent of the GNP, to about 13 percent.

I have a footnote in the text that I will just allude to now and perhaps devote further attention to later. The point is that one of the standard, but I think seriously misleading, practices in the sometimes polemical writing on this matter about the U.S. savings rate is to calculate the savings rate as net savings expressed as a fraction of gross national product, thereby shrinking the rate by 9 or 10 percent. This practice is both bad accounting and bad economics. It is bad accounting because depreciation charges should not be left out of the numerator if they are included in the denominator.

And it is bad economics because a relatively large proportion of U.S. plant modernization, as well as the technological advancement embodied in new equipment, is accomplished through capital consumption allowances and depreciation charges, which are nontaxable business expenses. Omitting these gross savings omits a major source of plant modernization. Those who are guilty of this practice include many people who should know better and some who do.

Let me return to the text. The aggregate savings rate has declined in the past decade by about 3 or 4 percent, while aggregate investment has remained at about the 17 percent figure. This 3 or 4 percent difference has been reflected in the current account deficit. In fact, it is exactly equal to that deficit. To reduce or eliminate the current account deficit implies either a reduction in investment or an increase in savings, or a combination of the two.

While the precise determinants of the savings rate, as well as its accurate measurement, are imperfectly understood and controversial—and I agree with Dr. Friedman's remarks in answer to the question raised earlier on that matter—the Government budget is clearly one of the important influences on aggregate savings.

This follows from the accounting identity that gross savings represent the difference between GNP and the sum of private consumption spending and Government spending on goods and services. So, at a given GNP level, gross savings are reduced by either higher consumption or higher Government spending.

Government purchases of goods and services reduce aggregate savings, whether the Government spending is financed by taxes or by borrowing. The variable that matters is the magnitude of Government spending. How it is financed, whether by borrowing or by taxes, is of secondary importance in its effect on savings.

To the extent that taxes reduce savings, which they partly do, and Government borrowing reduces private consumption, which it partly does, the size of the Federal budget deficit is of secondary importance, while the magnitude of Government spending is of primary importance in its effect on savings.

Of course, I agree that there are good reasons for wanting to see the Federal budget deficit reduced—to keep interest rates down, to dampen inflationary expectations, to restore fiscal policy as a credible instrument for countering recessions, and finally, to convey, internationally as well as domestically, the image of a responsible Government that lives within its means.

While acknowledging these points, I think it is worth adding a few heterodoxical comments to clarify, as well as to extenuate the effects of the Federal budget deficit. I have three points by way of extenuation of the effects of the Federal budget deficit. To say it plainly these effects are not all bad!

First, from the standpoint of the effects of budget deficits on credit markets and the international accounts, what matters is the consolidated budgets of the States as well as the Federal Government, not the Federal budget alone, because the States have amassed a substantial aggregate budget surplus in recent years—

and for various reasons that we can go into later—are likely to continue to do so.

The consolidated deficit shrinks by $50 to $60 billion at an annual rate. So, the consolidated budget deficit that results from the current year—that is, consolidating the Federal and State budgetary accounts—is in the neighborhood of $100 billion or about 2 percent of the United States GNP, a figure that is not out of line with comparable ones in Japan, West Germany, or the United Kingdom.

Second, the Federal budget deficit exercises a braking effect on the otherwise strong political pressures in a pluralistic democracy for Government spending to rise. In general, there is a small negative, but statistically significant relationship between the size of the Federal deficit in 1 year and the increase in Federal spending in the succeeding year, net of inflation and net of debt service.

If the deficit is higher in 1 year, after allowing for the effects of inflation and debt service, the increase in Federal spending will tend to be less in the succeeding years. Thus, deficits exercise a small but statistically significant braking effect on the tendency of Federal spending to rise.

Finally, as Bob Eisner of Northwestern has demonstrated, there is a substantial component of capital formation in Federal Government spending. Eisner has estimated this component at between $100 and $250 billion annually—the higher figure depending on whether military procurement and military R&D are included.

Now, even if you take the smaller figure, it is not inappropriate to finance genuine and productive public infrastructure—public capital formation for roads, bridges, airports, harbors, and so on—by Government borrowing because this infrastructure contributes to improved functioning of the economy and to widening the tax base, provided the capital expenditures have been wisely selected in the first place.

Turning to the other twin—the trade deficit or the current account deficit—there are encouraging signs that the trade deficit is already diminishing under the impact of two powerful market forces—the lowered exchange value of the dollar and the discipline imposed on U.S. producers by having to compete for market share with foreign imports within the United States and with foreign products in world export markets.

As a result, the trade deficit, in 1988, will be about $137 billion—more than $30 billion below the $170 billion deficit of 1987. The 1988 figure, in my judgment, will probably decrease further in 1989 by another $20 to $30 billion.

As the United States trade deficit declines, the adjustment problem this will create for the rest of the world will probably be considerable greater than that for the American economy. It is too easy for our friends in Western Europe and East Asia to forget that for the U.S. trade deficit to diminish, their trade surpluses, especially Japan, West Germany, and the Asian NIE's—the new industrialized economies—will have to decline, or they and other countries will have to experience trade deficits, or some combination of the two will have to occur.

One finds much more criticism these days from Europeans and Asians concerning the need for the United States to do something about its trade deficit than recognition of what this implies for their own economies. And these implications remain, whether the U.S. trade deficit is reduced by actions that affect the budget deficit, the savings rate, or U.S. investment.

This prospect, on which my view is somewhat more optimistic than that of my colleagues, could be adversely affected by one development that has generally been overlooked The attractiveness of U.S. assets, including real property, to foreign investors—may propel a continued strong desire by foreigners to invest in the United States, in the process raising the dollar's value and impeding the downward adjustment of the U.S. trade deficit. It is worth bearing in mind that capital flows can generate a trade deficit, rather than being generated by it.

In sum, neither deficit warrants alarm. The Federal budget and the trade accounts are less significant indicators of the economy's health than are the maintenance of sustained real economic growth, high employment, and low inflation.

Let me conclude with two very brief comments that are not in my testimony, but relate to points that have come up along the way. The first relates to the oft-repeated statement that the United States has an external debt of a half trillion dollars.

It turns out that the figures of the Department of Commerce are off by about $300 billion in overestimating U.S. foreign debt. The reason they are off—and RAND has done some work on this which I will be glad to send the committee—is that they treat the valuation of equities, of loans, of direct investment and real property, and of gold very differently from one another. Clearly, the correct way to treat all of those assets, whether they are holdings by Americans abroad or holdings by foreigners within the United States, is to attempt to mark them to market.

Now, when the Department of Commerce treats the valuation of equities it does that. It marks to market U.S. assets held in the Tokyo and London exchanges and it endeavors to mark to market foreign assets held in the U.S. equity markets.

When the official figures evaluate foreign loans held by the United States abroad and held by foreigners in the United States, they value those loans at their face value. That procedure is clearly wrong because—and this impacts adversely on the U.S. net international investment position—because holdings of the LDC debt that we have—Brazil, Mexico and Argentina—should be marked down, should be reduced by somewhere between 30 and 50 percent, according to the discounts we observe on their debt in the secondary debt market.

When the Department of Commerce values direct investment, including real property, it values those investments at book value not market value. If you just stop to think for a moment, U.S. foreign direct investment, including real property, has been accumulated over a 20-year period, whereas foreign accumulations in the United States have been concentrated in the last half-dozen years.

So, the effect of marking to market U.S. direct investment and foreign direct investment in the United States—U.S. direct investment abroad and foreign direct investment in the United States—is to increase by some $260 or so—$270 billion—the net holdings, the net value of U.S. holdings abroad.

And finally, in valuing gold stocks, which are the fourth major component of the Commerce Department's calculations, they value gold holdings at $42 an ounce, rather than $380 or $400 an ounce. When these various corrections, upward and down, are made for these four components of the international investment position of the United States, the net change in the U.S. position is about plus $300 billion!

Now, a check on this is simply looking at the current account—or the balance of payments—data for the U.S. economy. Up through 1987, the United States was earning something like $20 billion more from its holdings abroad than foreigners were earning from their holdings in the United States, including reinvestment of earnings.

In 1988, these net earnings were smaller, and the final figures are not yet out. But they will be smaller. So there is a trend that is accurately reflected in the comments that have been made in the public, and frequently polemical, discussion of this matter, but the basic underlying data are just plain wrong.

The final point, which is no less argumentative or at least provocative, I hope, than the preceding comment, is that we should try to do something about our savings rates. I think the question that was raised about explaining the higher Japanese rate is a cogent one, and Dr. Friedman's response that we really do not know is a good and accurate response. There certainly are cultural elements, but there are also policy elements. Japanese policies have consciously and significantly affected and promoted savings. And the Takeshita proposals, the tax reform that Mr. Takeshita has concluded, which is to reduce income taxing and increase consumption taxing, seems to me to be exactly the right policy but in the wrong country! In other words, I think that this is just the direction the Japanese should not be moving in.

But, on a positive note, I would suggest that the following suggestion is worth consideration to affect the U.S. saving rate; that is, to reduce the tax deductibility of interest payments by one-half and to allow tax deductibility of interest earnings up to one-half. So this would be revenue neutral, but it would have the effect what economists refer to as a substitution effect; namely, increasing the relative benefits from saving, while increasing the costs of consuming. I think over time it would have an effect on the U.S. savings rate.

Thank you, Mr. Chairman.

Chairman Sasser. Thank you very much, Dr. Wolf.

Professor Friedman, you have been accused in your recent book, "Day of Reckoning," which many of us on the committee have read, of being overly gloomy in your outlook and in your predictions and in your assessments. There are some among us who say that we should not be this concerned about the deficit; that we can grow our way out of it; and they indicate as evidence that the deficit as a percent of gross national product is, indeed, going down from the high water mark of 1985 and 1986, and is predicted to go down in the out-years.

How do you respond to those critics who say that we are being too gloomy in this whole assessment of the deficit problem and that we need to just continue to carry on as we are, and we will grow our way out of it?

Dr. FRIEDMAN. Mr. Chairman, I would answer that in several ways. First, a part of the narrowing of the deficit from 1985 to the present has come from the regaining of full employment in our economy. We were not at full employment in 1985. We may or may not be today, but we are certainly a lot closer today than we were 4 years ago. Therefore, to the extent that we have made a large stride toward full employment, we have eliminated that part of the actual Federal deficit that did not correspond to the structural deficit—namely, the part of the deficit that would be there and, indeed, still is here today, even at full employment.

The second response I would make is to recall a part of what I said in my summary of my prepared statement. More than half of the decline in the deficit to date has reflected the application of the Social Security surplus for the purpose of offsetting the deficit in the general account. The peak in the deficit was $221 billion, 4 years ago. Last year the deficit was down, to $155 billion, but that $155 billion deficit included $41 billion of surplus in Social Security. So, for that 3-year period—again, a 3-year period in which we substantially narrowed our distance from full employment—and on many accounts actually returned to full employment—the full extent of deficit narrowing was from $221 billion to $196 billion. Hardly an impressive amount.

Then, finally, you correctly say that some people predict that we will grow our way out of the deficit. The question is: Predict on the basis of what? What kind of revenue projections? What kind of economic growth projections underlying those revenues? What kind of assumptions about, for example, how much in interest payments the Government will have to spend; how much it will cost to clean up the nuclear plant problem; how much it will cost to solve the savings and loan problem.

The combination of economic assumptions underlying the President's proposal—in particular the assumption that we will have a sharp acceleration of economic growth, coupled with a deep decline in interest rates—is just not very realistic. My sense is that private forecasters throughout the economy largely agree with that. Similarly, the administration has been optimistic on a variety of fronts, for example, about how much cleaning up the nuclear problem will cost.

Therefore, I do not think it is right to say that we have made very great progress to date. Similarly, I do not think it is right that we are going to grow our way out of the deficit in the future.

Chairman SASSER. I am going to yield to Senator Fowler for a question. He has got to go to another committee meeting, and he has a question that he wants to propound here.

Senator FOWLER. Thank you, very much, Mr. Chairman.

Mr. Jones and Professor Friedman, why don't we follow the suggestion of Mr. Wolf that we find in the Federal Republic of Germany and France and almost everywhere else, and count the State surpluses and our capital investments as part of the wealth of the Nation to be balanced off against what we describe as our budget deficits? What is wrong with that as an economic proposition, and why is it in error as an accurate reflection of the economic health of the country?

Dr. JONES. First of all, let me say that, conceptually, one of the reasons I do not count it is because State and local governments are supposed to essentially be in balance every year. Some years they are in surplus, but they have just moved dramatically into deficit, if we exclude the retirement funds, the great years——

Senator FOWLER. Year to year, you would count them in deficit when they were in deficit, and you would count them as surplus when they would be in surplus.

Dr. JONES. Yes; and, by the way, in my numbers which I offered in terms of savings as a percent of the economy and the amount of Government borrowing in relation to savings, you might say, they are included in the non-Federal Government portion. So State and local governments are not excluded from all of those ratios. But I just want to emphasize that many people who argued that the deficit is not as bad as perhaps some thought, if you included the surpluses, those were the golden years of 1984, 1985, and 1986, when State and local governments surpluses—again, excluding pension funds—moved up into the 22 billion range and even higher, depending on how you defined it. Now, we have them as of the end of last year down in the deficit range, with New York and Massachusetts being prominently displayed as deficit States.

My feeling is you are hanging the "close your eyes, ignore the deficit, it will go away" view on a thin hook if you include that State and local government surplus of some years ago, and particularly you are in trouble now with the overall State and local budgets at least temporarily in deficit.

In a practical way, I include the numbers, but I would be very suspicious of whether or not, now that we are in deficit in State and local governments, that we can work our way out of that problem immediately. To me, the Federal budget deficit is where we should still be focusing our attention.

Dr. FRIEDMAN. I think Mr. Jones got it right, Senator, but let me just offer a few further comments.

Senator FOWLER. Comment on this, and Mr. Wolf can speak for himself. He says the surpluses are $50 to $60 billion in the States. I do not have the figures in front of me, but there are balanced budget provisions in over half of the States, I think.

Dr. WOLF. Forty-three.

Senator FOWLER. How many?

Dr. WOLF. Forty-three.

Senator FOWLER. Forty-three of the 50 have balanced budget provisions, and most of those are in surplus, or at least were the last couple of years when we have had this economy.

Now, why is that not part of the wealth of the Nation?

Dr. FRIEDMAN. Let me take a crack at it, Senator.

The issue is not whether that wealth is wealth on the balance sheet of the Nation. It certainly is. There can be no doubt about that.

The question from the perspective that all three of us have taken this morning is whether the States are adding to the saving of the country in a way such as to offset the extent to which the Federal Government is subtracting from the saving. It certainly is. Mr. Wolf is entirely right that, in recent years, the State and local governments have been running surpluses that have amounted, at their peak year, to $65 billion.

I think there are two reasons for not placing too much emphasis on that. First, as David Jones has already mentioned, those surpluses have peaked. The peak year was 1985, when those surpluses for all 50 States combined added up to $65 billion. The surpluses have now shrunk by approximately 20 percent, and they are continuing to decline. So they are on the way down, not up.

But, second, substantially all of those surpluses are in the form of prefunding of the liabilities that State and local governments are obligated to pay in the future for the retirement of their employees, including at the State level a whole variety of employees, and, at the city level, primarily teachers but also firemen, police, and others. The point is that the States have committed themselves in advance, in the same way that the Federal Government has committed itself in Social Security. The States and cities have committed themselves to contractual obligations to pay retirement benefits, in the future, for current employees. They are now funding those liabilities for future payments by building up State and local government pension funds.

Senator **Fowler**. My time is up, and I do have to go. I would like to pursue it, but I say in all respect—because it is always fun for the students to say that to the teachers, to the professors—that I do not follow you. I mean, we do the same thing in the Federal Government. Social Security is nothing but that same contractual, we like to say, commitment that States have with their employees. We have got the whole Federal work force that we are contractually committed to, and that is included in our budget estimates, prospectively. I just have not seen a compelling argument for why we do not do this, when almost every other democracy includes in its capital accounts its expenditures, its investments, its bridges, its roads. Although they do not have the same comparable state system that we have, their local and regional arrangements are certainly comparable. And I am not trying to get the deficit artificially down. I just do not understand as an economic exercise, as well as an intellectual exercise, how we can continue to put all of our eggs into our Federal basket when we make our analysis.

Any follow-up that you might like to write me a letter on, I would be appreciative.

[The following was subsequently supplied for the record by Dr. Friedman:]

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March 21, 1989

The Honorable Wyche Fowler
United States Senate
Washington, D.C. 20510

Dear Senator Fowler:

When I testified last month before the Senate Budget Committee, you raised two questions that we did not have time to address adequately during the hearing.

First, you asked whether it is appropriate to allow for the surpluses now run by state and local government units (not every one, of course, but at least in the aggregate) in thinking about the damage being done to the economy by the Federal government's continued borrowing. The answer is a definite yes. To the extent that the state and local government sector is a provider of saving, thereby adding to the saving done by Americans both individually and through the businesses that they own, that additional saving compensates, in some degree, for the absorption of private saving by federal government borrowing.

The reason why I do not take great comfort from the state and local government's surplus, however, is that this surplus is now declining -- not just compared to a growing and inflating economy, but in absolute dollars. In 1985, state and local governments collectively ran a surplus of $65 billion. In 1988, that surplus was down to $54 billion. Compared to the GNP, the decline looks far steeper. Most economists familiar with the state and local government sector predict that this surplus will continue to decline, as a variety of states come under increasing budget pressure, and cities and counties have to increase their education expenses to accommodate the rise in the school-age population that will follow from the recent increase in the birth rate.

Looking farther into the future, one can see yet further reasons to suspect that this surplus will dwindle. As I mentioned at the hearing, essentially all of the surplus today comes from the excess of pension set-asides over benefits paid, within the pension funds of state and local governments. Like any corporation, these governmental units are funding, in advance, the accruing pension benefits that they will have to pay in the future. As time passes, however, the future will arrive. The workers whose pensions are now being funded will retire, and the rapid growth of the state and local government work force during the last several decades will inevitably translate into rapid growth in the population of retired state and local government workers. As these retired workers draw the benefits to which they will be entitled, the expenses of these pension funds will rise and the excess of set-asides over benefits paid will dwindle. In many states and localities, that excess will probably become a deficiency, and what is now a surplus of saving, added into the economy, will become the absorption of saving.

The second question you asked is whether we should count government-owned capital as part of the wealth of the United States. Once again, the answer is that we certainly should. Moreover, in many accounting systems -- that of the Commerce Department, for example -- we actually do.

Counting that capital as part of the national wealth does little to minimize the problems about which I and many other people are now concerned, however. Yes, the government owns a lot of resources. Anyone visiting Yellowstone National Park, for example, immediately knows that the government owns a substantial asset. Unless the government is preparing to sell Yellowstone Park to foreign investors, however, there is no way to convert that asset into a supply of net new saving to replace the saving that the government takes out of the economy when it borrows to finance its deficit.

A closely related point is that the government spends in part to create or acquire new assets -- for example, roads, highways, bridges, port facilities, harbors, research stations, and so on -- that, at least potentially, add to the productivity of our country. When that happens, it is possible that these government-produced capital investments add to our productivity just as much as, or perhaps more than, private business investments in new plant and equipment.

Unfortunately, however, in the 1980s -- just as the government deficit has risen to record levels -- the share of government spending going into civilian investment has fallen to a record low. It is simply not the case that we are "using the deficit" to invest in productivity-enhancing infrastructure capital.

I realize that these brief answers probably do not do justice to the full range of concerns you had in mind when you asked these two questions at the hearing. If you would find it helpful, I would be glad to give you whatever further information that you would like.

With best personal regards,

Sincerely yours,

Ben Friedman

Benjamin M. Friedman

BMF/hd

Chairman **Sasser**. Gentlemen, Dr. Wolf, I yielded to Senator Fowler for a question, and he has consumed all of my time, which I am pleased to give him. So I will defer to Senator Armstrong.

Dr. **Wolf**. Mr. Chairman, could I make a brief comment in response to Senator Fowler's question?

Chairman **Sasser**. If you will make it brief.

Dr. **Wolf**. Conceptually, it seems to me that from the standpoint of effects on credit markets, the State and Federal government accounts should be consolidated whether the States are in surplus or deficit or whatever. Because 43 of the States and probably an increasing number of the remaining—that number will increase—have constitutional amendments that oblige them, although occasionally they depart from what their constitutional obligation, to be in balance, it is predictable that they will typically and pervasively have surpluses. Those surpluses may not be $60 billion in 1987. I do think Dr. Jones' figure is wrong. It is more like $50 billion in 1987, and I do not know what it is in 1988.

They will predictably have surpluses if they have a legal obligation to be in balance, because their loss function is skewed; deficits aren't admissible, so errors will tend to be one-sided—that is, skewed toward surpluses.

The second point on the question of wealth is separate from the point about consolidating the Federal and State budget accounts. The point I was making is the one that Senator Fowler was picking up on; that there are parts of the Federal budget that represent public infrastructure. And provided you gentlemen are making wise and discriminating choices in those projects and uses of funds, those projects eventually represent an expansion in the tax base and in the productivity of the future economy. So it is appropriate to use borrowing to finance them.

Chairman **Sasser**. Thank you.

Senator Armstrong.

Senator **Armstrong**. Mr. Chairman, I want to be a little cautious about wading into this discussion. But, gentlemen, it appears to me that it is really not very important whether we keep the books as Senator Fowler has said or in some other way, because, in fact, what we are concerned with here is the macroeconomic effect which has nothing to do with how the books are kept.

Professor Friedman, I appreciated very much your statement. I thought the most striking part of it, if I may say so, was an issue which you raised in passing in which you identified the deficit problem primarily in moral terms. As I recall, you said that it was tantamount to selling our children's birthright, which is exactly the point that Thomas Jefferson made and others have made, and I compliment you for doing so.

I want to ask this question. You mentioned the Social Security fix, and I was not quite sure what you were indicating. Perhaps you were not even addressing this point, but I would like to inquire.

Is it your suggestion that the Federal budget deficit ought to be computed and dealt with separate of the Social Security trust fund?

Dr. **Friedman**. Yes, sir. I thought Congress did the right thing in 1983 in, in effect, moving the Social Security system off budget.

It is important to understand what the 1983 amendments were about, and why we are in the process now of undoing them now. As everybody knows, there will be a large retirement bulge in the United States when the baby boom generation hits age 65 or so, that is, starting roughly 20 years from now. Six years ago, Congress and the President agreed to do something to avoid the dilemma that would occur, starting 20 years from now, if we did not prepare for that event. At that time the ratio of retirees drawing benefits to workers paying in contributions, which is now roughly one to five, will shrink to roughly one to three.

Senator **Armstrong**. If I could, your point is well taken, but it is a little different one than what I was trying to seek your opinion on. If we, in effect, ignore the Social Security trust fund at a time when it is running large surpluses, and we then balance the budget, ignoring the trust fund surplus, the result obviously would be quite different than if we take those surpluses into account.

Dr. **Friedman**. Yes, sir.

Senator **Armstrong**. My question is: If we do that, which I gather you favor, if we exactly balanced the Federal budget otherwise, the result would be a very large annual reduction in the amount of Federal debt outstanding. In your view, is that desirable?

Dr. **Friedman**. Yes, sir. The proposal that I have advanced is not to balance the rest of the budget, but to run a $60 billion deficit on the general account, and then to let the Social Security surplus build up undependently. We can go into that in more detail if you would like.

But you are exactly correct that if we run a $60 billion deficit on the general account in a year in which the Social Security fund is running, let us say, a $110 billion surplus, then on a net basis the Government is actually taking out of circulation $50 billion worth of Treasury securities. That is $50 billion of investable funds that the Government is putting into the markets rather than taking out. That then adds to our saving. One possibility is that we will invest that additional saving at home, in which case we will build up our national wealth, our stock of productive capital, so that we will be better able to support the baby boom generation when it retires. Alternatively, instead of building up our domestic capital, we may invest the additional saving abroad. Then we would be able to earn additional interest and dividends from abroad.

So, your idea is exactly right. To get ready for this bulge in the retirement population, the Government should strictly be adding to our national saving rather than subtracting. And as the way to do that, I suggest that the Government run a $60 billion deficit on the general account at the same time that the Social Security system runs the surpluses that the actuaries tell us will be there.

Senator **Armstrong**. Thank you, Professor.

Mr. Wolf, it seemed to me that of everything that has been said today, the most important single statement begins on page 2 of your testimony, that the issue really is the level of Federal spending, that the big effect upon savings is determined by the level of Federal spending rather than how it is financed.

I do not need to ask you anything about that. I just want to note in passing that I agree with it. It is a notion that Professor Friedman's namesake, Milton Friedman, has often argued, and others. And I think it is a point that is well made.

I think the chairman is about to come back and tell me that my time has expired, but before he does——

Senator **Exon** [presiding]. This chairman is about to tell you, but the light is on so you go right ahead.

Senator **Armstrong**. He passed the gavel, Senator.

If I could have just a moment more, let me say to Dr. Jones that if I really believed that Wall Street was hanging on the words of Senators, as you have indicated, I should really be alarmed about the future of things around here.

My observation is the opposite; that the discount which Wall Street applies to all of the rhetoric from Capitol Hill is very, very large. And it is an interesting contrast between how Wall Street treats the pronouncements of the Fed chairman versus how they treat the pronouncements of Senators or even the statutory enactments of the Congress.

It seems somehow that the more florid the rhetoric is from Capitol Hill, the less attention is paid on Wall Street, and properly so. But Chairman Greenspan and his predecessors have been treated with such respect and deference that their problem is they cannot say anything. They cannot sneeze but that somebody thinks that that means that the interest rate is up or down or some calamity is occurring.

I for one am reassured by the fact that we have a lot of room for maneuver and mistake around here because our pronouncements are taken with a grain of salt.

Dr. **Jones**. Let me qualify a bit. Your comments are extremely well taken. Let me qualify mine a bit.

Actually, I think Wall Street does discount certain levels of rhetoric, particulary the question of, let us say, in fiscal year 1989 whether we are going to come close to Gramm-Rudman. I mean, every year we get a little more skeptical. We are probably coming in at $170 billion on fiscal year 1989 budget deficit, and Gramm-Rudman—if my memory is right—is somewhere in the $136 billion range.

That kind of numbers game is being met with increasing skepticism, and in that sense, Senator, your comments or the committee's comments or even Capitol Hill's comments in general on the numbers perhaps are somewhat discounted.

But let me say this: That my sense is that it is not the case in the international capital markets. In many cases, they have some difficulty figuring out where the ball is, whether it is in the President's hands or in the Congress's hands on this budget matter. But I want to say that numbers still do count, oftentimes, in talking to large, international portfolio managers of money. And so do not underestimate your deliberations in that sense. Perhaps it is a "two tier" mechanism. Wall Street itself, the domestic money managers, have become a little skeptical about all the numbers, but in the international markets, there is still a great deal of attention.

Finally, to me, the key here is whether or not we can reconcile the budget story with the Fed story. It is very true that Fed chairmen seem to have a lot of press, and almost immediately. And you are absolutely right, they cannot say anything without some kind of market overreaction to the Fed chairmen.

Senator ARMSTRONG. It is because they say little and act decisively. We do the opposite.

Dr. JONES. That is exactly right. They do not have to say much. One of my rules of Fed-watching is: Do not listen to what they say, watch what they do. Maybe that is what we should apply to Congress, but I am not going to try to be an expert on that.

Senator ARMSTRONG. Thank you, Mr. Chairman.

Senator EXON. Thank you, Senator Armstrong.

I will yield my turn to my good friend from North Carolina. I understand you have to leave, Senator Sanford.

Senator SANFORD. Thank you very much.

Let me thank all three of you for being here and for presenting very good testimony. I have read it all, and I thank you so much for your time.

Let me ask Dr. Wolf a couple of questions. He made me feel so good. I was just about to close my book and go on to something important and leave this deficit alone.

I was interested in your statement, which is doubtless true, that to reduce or eliminate the current account deficit, you either have to have a reduction in investment, which has stayed pretty steady, or an increase in savings, or obviously some combination. You have got to get them closer together.

I take it that reduction of investment is not really an advantage and would have many disadvantages. How do we go about improving aggregate savings? What can we do in the Budget Committee or what can Congress do to increase savings?

Dr. WOLF. I ventured to suggest one option for consideration, and I have not thought this through or analyzed it carefully. But it seems to me to be something that you can consider, and depending on the outcome of your consideration, do what would seem to me exactly appropriate. I cannot say whether that would have the effect of this 2 or 3-percent GNP increase in savings, but it would move in that direction; namely, to reduce the tax deductibility of interest payments by a half, or some proportion, and to allow tax deductibility of interest earnings by that same proportion. That could be configured so it is revenue neutral, and there would be no new taxes involved, just changing arrangements relating to present tax deductibility.

Senator SANFORD. No new taxes overall, but new taxes for some individuals?

Dr. WOLF. New taxes for some individuals, but, in effect, the tax deductibility of interest payments would be reduced. But it would not be a new tax. This may become semantic, but, anyhow, regardless of whether it is no new taxes or not——

Senator SANFORD. Well, if I have a chance, I want to come back to Dr. Friedman and Dr. Jones on that question. But let me ask you another question before we pursue this again, if I have time.

What is your definition of the deficit?

Dr. WOLF. The budget deficit or the trade deficit?

Senator SANFORD. The budget deficit.

Dr. WOLF. Well, Senator Sanford, I——

Senator SANFORD. Are you taking our figures or are you looking for yourself?

Dr. WOLF. I am sorry?

Senator SANFORD. Are you taking our figure of what the deficit is under Gramm-Rudman, or are you looking behind for those figures for yourself?

Dr. WOLF. No, no, I am taking your figure. I include the Social Security surplus because, from the standpoint of the impact of the Federal deficit in terms of Federal borrowing on public capital markets, that is reduced to the extent that Treasuries are sold to the Social Security Trust Fund. So the pressure of Federal borrowing on credit markets is reduced to the extent that the Social Security Trust Fund is in surplus.

Senator SANFORD. Is there from an accounting point of view any difference, within a few billion dollars for some technical reasons, but is there any difference in the gross national debt increase and the deficit by accounting terms?

Dr. WOLF. The gross national debt is the accumulation of the national deficits over time.

Senator SANFORD. Yes, the annual increase in debt?

Dr. WOLF. Yes.

Senator SANFORD. That is the deficit?

Dr. WOLF. Right.

Senator SANFORD. Well, that is now in the neighborhood of about $240 billion, and has been somewhere in that neighborhood for 7 or 8 years. We come down from that figure by using numerous devices.

One of the biggest is probably now the interest paid on the trust funds that is deducted and converted to net interest.

Dr. WOLF. Yes.

Senator SANFORD. And the second is the annual surplus, if you will, in the trust funds, Social Security and others. Even by juggling, the deficit in 1988 still climbed to $155 billion under Gramm-Rudman. But, in truth, it was closer to $240 billion.

My point is, we are fooling ourselves. Would not deficits count a little more if we knew the true size of them? Is it not more frightening to have a $240 billion deficit than a $100 billion deficit?

Dr. WOLF. It would be of greater concern to have a $240 billion deficit than a $100 billion and—whatever your other figure was.

Senator SANFORD. Well, we claim we have got it down to $100 billion in President Bush's budget.

Dr. WOLF. I do differ from Dr. Friedman in taking the position that I thought came out of the exchange between him and Senator Armstrong that from the standpoint of impacts on the credit markets, the surpluses in the Social Security Trust Fund, as well as the surpluses in State pension funds, reduce the pressure of public borrowing on credit markets. And from that standpoint, they are proper to include in the calculation of the deficit.

Senator SANFORD. Yes. Well, that is all very true as a theory of economics, but when we come right down to it, should we worry about this deficit? Should we try to do something about it?

One deficit is not so much, but we now have an accumulation of deficits now approaching $3 trillion. Shouldn't we really be seriously worried about that?

Dr. **Wolf**. Well, I suggested on page 3, if that is the right one, the very substantial reasons for being acutely concerned about the deficit and trying to do something about the deficit relating to reducing the upward pressure on interest rates from Government borrowing, damping inflationary pressures, restoring the credibility of compensatory fiscal policy as an antirecessionary instrument, and affecting the image of the U.S. Government as living within its means.

I think those are compelling reasons, but those aren't the reasons that, it seems to me, the public and, frequently, polemical discussion of these matters have displayed. But they are still good reasons.

Senator **Sanford**. Thank you very much. I regret my time is up.

Chairman **Sasser**. Senator Grassley.

Senator **Grassley**. Yes, thank you very much, Mr. Chairman.

In trying to benefit from your collective judgments on what is the correct fiscal policy, I am drawn not only to your differences, but also to your consistencies. And if I understand each of your positions, the overall savings rate in this country ought to be increased. Would that be true for all of you?

Dr. **Wolf**. Yes.

Dr. **Jones**. Yes.

Senator **Grassley**. Mr. Friedman, you didn't nod your head.

Dr. **Friedman**. Yes.

Senator **Grassley**. OK, thank you.

Is it also true that if savings are to grow, consumption and borrowing have to be diminished?

Dr. **Jones**. Yes.

Dr. **Friedman**. Yes.

Dr. **Wolf**. It is true that for savings to grow, consumption has to decrease.

Senator **Grassley**. OK, but you aren't saying that——

Dr. **Wolf**. I am not saying that borrowing has to be decreased, no.

Senator **Grassley**. OK. There might be some difference there, whether that borrowing is for capital as opposed to for consumption, right?

Dr. **Wolf**. Right.

Senator **Grassley**. So we would agree that you can have borrowing, but for capital formation as opposed to consumption?

Dr. **Wolf**. Right.

Senator **Grassley**. OK.

Dr. **Wolf**. If I could interject one point to explain that demurral on my part, there are differences among economists on the extent to which this so-called Ricardian equivalence theorem, to use the jargon, which means simply that "rational" borrowers who borrow for consumption purposes will subsequently reduce their spending, increase their savings, because of the anticipation that they have to pay back on the borrowing or pay taxes to the Government that will be greater to service the Government borrowing——

Senator **Grassley**. OK. Well, now, it seems to me like there is one point where there is disagreement among you, and that is how to reduce the deficit, whether it makes any difference if we reduce it by increasing taxes or lowering spending.

So, then, my question is if we are agreed that savings must be increased, doesn't it make sense that less spending and taxes is better than, or at least less onerous of a combination.

And what I am really after here is, consider we are politicians. You have gone through this in your discussion between how the Reserve Board operates as opposed to Congress. What I am after here is, think in terms of you being economists, we are politicians, and there is a political vacuum here.

That is how I would like to have you answer that question in regard to these two options, if I could have each one of you do that.

Dr. **Friedman**. I will try to answer your question, Senator. First, I think you have put it exactly right. What we need to do is to increase our national saving rate. That we can do either by increasing private saving or by reducing Government dissaving.

I think one of the main lessons we have learned in the 1980's is that we don't know how to increase private saving in the United States. The landscape is littered with proposals that we enacted early in this decade on the promise that they would lead us to increase our private saving. We reduced taxes, we got inflation down, we had special incentives for various forms of investment vehicles. We cut the capital gains tax rate. We had expanded IRA provisions. All of these devices added up to a dramatic decline in private saving during the 1980's.

The main lesson to carry away from that experience is that, while experimenting further would be nice—and in that vein, I think the proposal that Charles Wolf has suggested is just as deserving of an experiment as anything else—we really don't know how to increase private saving.

What we do know how to do is to reduce Government dissaving. From an economic perspective, I don't think it matters a lot whether we do that by cutting Government spending, down to the level at which we are prepared to tax ourselves, or by raising the taxes up to the level at which we want to spend. I could imagine doing it either way. Within the spending side of the budget, there are certain programs that are promoting of productivity and others that are not. And within the tax side, we can all think of taxes that are better, and taxes that are worse, than others in their economic effect. But what we ought to do is to get on with the business of reducing Government dissaving by whatever combination of spending cuts and/or tax increases you, in your capacity as our elected legislators, think is the right combination.

Senator **Grassley**. But, see, my question to you is, and it won't take you long to answer it, as an economist not in the political world, but in a political vacuum, what would you choose?

Dr. **Friedman**. I personally would choose is to do half on the spending side and half on the revenue side, and I would choose——

Senator **Grassley**. But you are doing that for economic reasons and not for political reasons, right?

Dr. **Friedman**. No, sir; no, sir——

Senator **Grassley**. OK.

Dr. **Friedman** [continuing]. Because I don't think it matters a lot. As to economic reasons, I think there are things we shouldn't do. For example, we shouldn't do again what we did in the 1986 tax bill, and explicitly get rid of incentives for investment like the ITC and liberalized depreciation. We shouldn't go eliminating programs that build Government infrastructure. Those are things we shouldn't do. But beyond that, as an economic matter, I don't think it matters a lot.

Senator **Grassley**. Could we have just the last two people answer the question?

Chairman **Sasser**. Yes; try to keep the answers brief.

Dr. **Jones**. I will just address the question of cutting the deficit. I share Professor Friedman's view on the question of increasing national savings and the appropriateness of at least using that as one attempt.

In reducing the deficit, there is, it seems to me, a political constraint here and a conflict between my economic view and my practical market view as what you can actually accomplish in this Congress, I think.

If I would say where should spending be cut in a way that the markets would be convinced of credibility, it would be in such areas as Social Security, which is virtually impossible, I know, for you to achieve politically, or perhaps in the defense area to some degree.

But defense cuts, to me, are a longer-term process; they will depend on arms negotiations and how many weapons systems you choose between. That may be a 4 to 5-year process even if everything goes right with the Russians and the process of disarmament. So, to me, it is not a 1990 story in terms of a significant cut in defense.

Therefore, I come up with very little more that can be done on the spending side, with the possible exception of the administration's "black box" spending freeze proposal, which I am having trouble with. Mr. Darman may have talked about that yesterday.

Chairman **Sasser**. Well, he did so reluctantly, Mr. Jones.

Dr. **Jones**. I see. So I come to the tax side, and I have got an offer, not that I am in favor personally or otherwise of raising taxes, but a gasoline tax increase of 25 or 50 cents a gallon would raise $25 or $50 billion and be highly credible. That is my offering for today, although there is a good debate over that.

Chairman **Sasser**. And credible to the markets.

Dr. **Jones**. Yes, credible to markets in terms of concrete deficit-cutting actions.

Dr. **Wolf**. Senator Grassley, my answer to your question is unequivocally stated on the bottom of page 2 of my testimony. The variable that matters is the magnitude of Government spending. How it is financed is of secondary importance in its effect on savings.

Chairman **Sasser**. Thank you. I am sure that gasoline tax will go over well in Iowa, Dr. Jones. I expect Senator Grassley to rush out and endorse that.

Dr. **Jones**. Well, I am from Iowa, so I may be in double trouble here.

Dr. **Friedman**. Mr. Chairman, may I just add one thing that might be of use to Senator Grassley?

Chairman **Sasser**. Yes.

Dr. **Friedman**. A recent Harris poll that shows that, of all proposed increases in taxes that everybody would expect to pay, the one that is least disfavored is a national sales tax or a value-added tax.

According to the poll results, there is no increase in taxes that the average citizen would expect to pay that commands a majority support in the public. But the majority disfavoring a national sales tax—or value-added tax—is now down to only 50 to 47. Perhaps that may be helpful.

Chairman SASSER. Senator Exon.

Senator EXON. Thank you, Mr. Chairman.

Gentlemen, I will try and stay within my time frame because I know you would like to get out of here and the other people have some things to do here, also.

I would like to ask you this question first, Mr. Wolf. I take it from your testimony that while you are concerned about the twin deficits, you don't believe that they are any immediate problem as far as our economy is concerned. Is that a fair characterization of your statement?

Dr. WOLF. Yes, it is.

Senator EXON. Have you always felt that deficits were not a problem or are you one of those who have been converted in the last 8 years?

Dr. WOLF. No. As I said in the concluding sentence of my testimony, I think the cardinal indicators of the economy's status and performance are real growth in GNP, level of employment, and the level of inflation.

And whether deficits are high or low, I think, is a tertiary consideration compared to those cardinal measures of performance. I would say that the question of productivity is another one that I would add to that triad.

Senator EXON. Let us go back to 1980 so that I can understand what you are saying. If my memory serves me, we had a budget deficit of about $70 billion, in that general area. You thought that that was not a problem then, then, is that right?

Dr. WOLF. Right, yes.

Senator EXON. Thank you. Let me go to another question. There have been an awful lot of statements made by an awful lot of people recently that we are going to have $80 billion more to spend—you know, read my lips—this fiscal year.

Am I right in thinking that about $14 billion of that $80 billion that is going to come in—about $14 billion is a further increase in revenue from Social Security taxes? Is that basically right?

Chairman SASSER. About $26 billion, I think, Senator Exon.

Senator EXON. Is it $26 billion?

Chairman SASSER. Yes, increase in Social Security revenues.

Senator EXON. You know, I think that is a terrible misnomer that some people are putting forth on the people of the United States. They hear about, we have got a huge surplus, you know, of $68 billion in the Social Security Trust Fund, but we are not spending that.

Yet, the President of the United States, no less, says we have got $80 billion more to spend for next year. Just to start out, trying to be fair, shouldn't we subtract the $26 billion, or whatever it is that is Social Security? That isn't there to spend, is it?

Otherwise, we are spending "Social Security Trust Fund" money, which is supposed to be taboo. Do you think that should be subtracted off?

Dr. **Wolf**. It depends what purpose the subtraction is performed for, Senator. I think that money isn't there to be spent. On the other hand, as I said earlier, from the standpoint of reducing Government borrowing on public capital markets, that money is a subtraction; that surplus is a subtraction.

Senator **Exon**. The point I am making is that however we do this, go back to the capital budget discussion that we had here a few minutes ago. I don't care what we do or how we do it. What I object to is the dishonesty in budgeting that is practiced in Washington, D.C., much more so than it ever is at the State level or more so than it is in private businesses or private family incomes.

We have got to be honest with the people and tell them where we are. The facts of the matter are not very many people in the United States understand that the Social Security Trust Fund—there is no fund and there is very little trust because it is gone.

All we have got is a cash register that says "Social Security" on it, and up there it says there is $68 billion in here. You open the till and there are a bunch of IOUs in there.

What we have done, basically, is to raise Social Security taxes, which the people went for, and we are using that money basically as a spending mechanism. Therefore, when people, whether they are running for President of the United States or not, say they are not going to spend Social Security money and then get on the air and tell the people we have got $80 billion more to spend, we are spending Social Security money, and sooner or later we are going to have to answer for that to the people, but I am not sure they understand it yet.

One last question. I have been skeptical of Gramm-Rudman-Hollings. I voted against it because I felt at the time, and I think my feelings have been vindicated, that it is more of a device to control projections rather than the deficit.

For example, OMB said we were going to have a $136 billion at the end of last year and it boomed to $170 billion. I have thought maybe we should tighten that up by tying the increase in the deficit on a yearly basis to when we expend or raise the national debt.

And if we make bad projections or don't have enough revenue or spending is too high, then it would take a three-fifths majority of the Congress to expand the debt; in other words, make some accountability.

Do you think that would be maybe more effective than the present mechanism in Gramm-Rudman, and would it work?

Dr. **Wolf**. Well, I think that is a splendid idea. I am not quite sure how that provides a discipline to you gentlemen.

Senator **Exon**. Because you couldn't raise the debt ceiling unless you got a three-fifths vote of the Senate to do it.

Dr. **Wolf**. I think that is an interesting suggestion.

Senator **Exon**. Mr. Friedman, Mr. Jones, do you like it or don't you like it, and then I will yield?

Dr. **Friedman**. I would favor building in some more discipline in the process, Senator, but I have two things to say. First, I am not sure this is a good setting in which to do it. Both the ways you suggest—tying it to the past year's performance, and tying it to the debt ceiling limitation—are not ideal.

But second, I have the nagging suspicion that, unless there is some political will to stop promising the public a free lunch, to stop telling people that there will be vastly more economic growth than there is really going to be, to stop telling people that they don't have to give up programs on which they rely because the entire budget consists of waste and fraud and abuse—until we get beyond that, my guess is that any mechanical hurdle that Congress sets for itself, Congress and the administration together will be able to jump over.

Senator **Exon**. We have a track record in that regard.

Mr. Jones.

Dr. **Jones**. Senator, let me say I share totally your view that what is really being watched here is the old story of fiscal discipline, and we can juggle the books a lot of different ways to obscure the discipline that is required to equate revenue with spending. But the fact comes back down to we can't talk about that extra wonderful $80 billion without deceiving the public. I think you could not have said it better.

With respect to the debt ceiling issue, let me just say from a financial market standpoint, I chill a little bit on that one simply in the sense that it tends to cause the Treasury—I look at this at the back end of the pipeline. You folks are at the front end of the pipeline deciding on how much spending and how much revenue or how much of a free lunch is going to exist this year.

We are sitting in the financial markets at the back end of the pipeline, hoping that we can calculate what this pipeline is going to give us in terms of debt. What happens when we run up against the debt ceiling problem is we run into great problems of the regular scheduling of Treasury debt, and that can be a disaster and it can also cost the Government a lot more money if we have a big backup against the debt ceiling because then we have to come out with a lot of debt after the ceiling is adjusted.

So I just make a small plea here not from the point of view of fat cats on Wall Street, but from the simple realities of getting the pipeline right at the front end in terms of revenue and spending instead of waiting until we get to the back end of the pipeline when the money has to be borrowed to finance the difference between too much spending and too little revenue.

Chairman **Sasser**. Thank you.

Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

Very briefly, would all three of you agree that what is important in terms of measuring our deficits and debt is on a percentage of GNP basis; that that is more important than dollar levels? Would all of you agree with that?

Dr. **Wolf**. Yes.

Dr. **Friedman**. Yes.

Dr. **Jones**. Yes.

Senator **Conrad**. I am correct in characterizing that we get vigorous nods of agreement from all three of you on that question.

The second question that I would ask—Mr. Wolf, you have indicated that "neither deficit warrants alarm." That is a quote from the last paragraph of your testimony. Mr. Friedman, I would like to get your reaction to that observation.

Dr. **Friedman**. It depends what you mean by "alarm," Senator. The deficit problem, including the Federal Government's deficit, and the inadequate investment that we are doing as a result, and the erosion of our international position that is also a result, is a long-run, gradual, corrosive process.

What we are doing is gradually eating away at our ability to maintain a strong and vital economy. We see that in things like disappointing productivity performances, the absence of growth in real wages, the increasing number of even high-tech industries in which now we discover we can't compete, the increasing pressure on you here in the Government to have subsidies for yet one industry after another. The signs are everywhere.

Now, does this mean that the world is going to come to an end tomorrow? No. Does it mean we are going to have a depression tomorrow? No. Does it mean that there is likely, within the foreseeable future, to be some highly visible, cataclysmic catastrophe, with tangible results that one can put up on a blackboard? No.

If anything, that just makes the problem all the greater, because our political system has always been best at responding to crises. Somebody recently said the crisis is that there is no crisis. If we had a big blow-out—I think the stock market crash of a year-and-a-half ago indicates what happened when people thought it was 1929 all over again—maybe there would be a greater sense of urgency. But too many people make the mistake of saying that, because our standard of living has merely stagnated and hasn't collapsed yet, because foreign investors don't yet come through the IMF door telling us what we must do with our policy, therefore there obviously isn't any problem. I think that is just wrong. Whether all that adds up to what you would call alarm, I don't know. I agreed with parts of Charles Wolf's testimony to the extent that this is a long-run problem and there isn't any threat to our economy this year or next year.

It is an ongoing process, and that makes it harder to deal with. But it is real nonetheless.

Senator **Conrad**. Well, I don't know what school of economics you went to, but I read your testimony and I must say whatever school of economics you went to is the one I went to. My staff came to me after reading your testimony and said, "this sounds like a page out of your bible." I sense maybe we are not really so much in disagreement here as a matter of emphasis.

I believe it has a corrosive effect on the economy. I believe we see a slow undermining of the economic strength and health of this country, not something that is cataclysmic, not something that is going to cause a problem tomorrow or next week, but it is ongoing.

I would be interested in hearing from Mr. Wolf on whether or not you view the trend line of the growth of national debt as a percentage of GNP as a troubling trend.

Dr. **Wolf**. Well, the growth of the Federal debt of $2.7 trillion as a percentage of the GNP is certainly higher than it was 8 years ago. It is still well within ranges it has been at in the last 30, 40 years.

Senator **Conrad**. The question I am asking, though, is the trend—we have had a 50-percent increase in debt-to-GNP over the last 8 years. Does that trend disturb you?

Dr. **Wolf**. No, because I don't think that trend is continuing. I don't want to paper over the disagreements that I think you have properly discerned among us because I don't see this corrosive effect on the American economy. I think the American economy is fundamentally healthy, with a set of problems to be worked on.

And among those, the principal ones that I have tried to highlight are the savings rate and the problem of dealing with our allies and their policies so that the adjustment on the current account trade deficit side is recognized as part of their problem as well as part of ours.

Senator **Conrad**. You don't see the United States economy as stagnating vis-a-vis that of our Japanese competitors or the West Germans?

Dr. **Wolf**. No, I don't. The rhetoric of decline that has been so highly publicized around the country, including in the halls of the Congress, I think, is a rhetoric that exaggerates what are serious problems, but by the exaggeration distorts them. The distortions obscure the very considerable signs of health in the economy which relate to real growth, to high employment, to generally diminished inflation, and to productivity that is more complex than we have time to go into, because in manufacturing productivity the United States is back on its secular rate of growth in productivity.

The problem of averages and aggregates arises because the services sector of the U.S. economy is now two-thirds of total value-added, and the rate of increase in services productivity is about five or six-tenths of 1 percent. So when you average together the minimal growth in services productivity with the say, 3 percent annual growth—at least as high as our secular long-term pattern of growth—in manufacturing productivity, the aggregate, the average, is low.

And I think that is probably as much due to the fact that we don't know how to measure services output so that we can compare the output of computer services or computer-assisted design capabilities now with what existed 10 years ago because those capabilities weren't in the services sector at all. So I think those are misleading indicators of apparent but not real illness in the economy.

Senator **Conrad**. I would just conclude that we clearly have a disagreement. I believe that we are in relative decline. I think the signs are everywhere of it, and having been in Europe and Japan, it seems abundantly clear to me that we are.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Conrad.

You have indicated, Professor Friedman, that as a result of budget deficits, you don't anticipate there would be any catastrophic collapse, as I understand it.

Dr. **Friedman**. Yes, that is right.

Chairman **Sasser**. This would have more of a slow, corrosive effect on the economy. And in your opening statement you cited as what I understood to be one of the corrosive effects the real wage of the average American worker falling. Did I hear that correctly?

Dr. **Friedman**. Yes, sir. This is the first business expansion in 50 years in the United States in which the average working citizen's wage is rising less rapidly than inflation. Today, the average citizen's wage is less, in 1983 dollars, than it was in 1983 when the business expansion began. This has a whole variety of reasons, but I believe that, if we were doing more investment in productivity-enhancing equipment, and building more plants to give people an opportunity to work in high-value-added jobs, that wouldn't be so.

Chairman **Sasser**. Well, could this be a partial explanation—for Dr. Jones' analysis that real net savings has fallen from 5.7 percent of GNP to 1.8 percent of GNP from 1981 to 1987, this very precipitous drop in savings?

Could this be attributable to the fact that real disposable income of the American workers is going down and that they don't have a surplus to save anymore; that they are simply spending it all to make ends meet?

I say that in the context—it appears to me that in the decade of the 1970's we saw an explosion of the two-worker family—that is, both husband and wife working—in an effort to perhaps maintain a standard of living that they had in the early 1970's that they began to see dissipating in the latter 1970's.

Now, with both of those two wage-earners out now in the decade of the 1980's and with, again, their real disposable wage being squeezed, for whatever reason, could that be an explanation for the savings rate coming down here between 1981 and 1987?

Dr. **Friedman**. Yes, sir, I believe that that is one among several possible explanations. Let me emphasize again, however, that we don't really know what is driving saving behavior in the 1980's. But the idea that people over a long period of time have gotten used to an increase in their standard of living—an increase which, after all, was supported in the past by an increase over long periods of time in how much they could earn—does lead to the suggestion, as you make it, that perhaps people in the 1980's, having gotten used to that over a long period of time, have continued to step up what they spend while on the other side they are simply not able to increase what they earn, and as a result the saving rate is now falling. That is one, among other, possible explanations.

Frankly, I would find it optimistic to think that that is why the saving rate has fallen, because, if that is so, then there is at least hope that sooner or later people will figure it out and the saving rate will go back up.

Chairman **Sasser**. Does anybody else want to take a crack at that?

Dr. **Jones**. Let me just say, Senator, that, in fact, it is a mirror image of two things, the idea that savings is falling behind here. To me, it goes back to the point that we are losing our way in the world in terms of competition, in part because of the inability to generate enough savings, to generate enough investment, to increase productivity and competitiveness to stay ahead in terms of world competition.

Like Dr. Friedman, I would share the view that as we have fallen behind in that process, the average family is caught in a bind. Their average real earnings are not going up as fast as they had been used to. They are trying to hold on to consumption patterns, and the residual effect there is low savings.

And I would simply add this, that it becomes a vicious circle. If we can't keep the savings up as a result of trying to make ends meet in a two-worker family as a country, and if we don't have any help from the Federal Government in terms of reducing that deficit or dissavings effect, we get into kind of a death spiral here in which we can't generate enough overall savings growth per year to finance investment, to finance improved productivity to compete in the world, and we fall behind.

To some degree, that happened in Britain, at least until Margaret Thatcher came along, and the last thing I want to see happen here is that process. So we do need to reorient our priorities here, and the first place to begin is bringing that Federal Government dissavings, or the budget deficit, down.

Dr. WOLF. Mr. Chairman, let me express disagreement with what has been said. I don't think that the explanation that you offer of diminished average real wages is an explanation for the 3-percent reduction in aggregate savings.

Chairman SASSER. Dr. Wolf, let me interrupt you just to ask you a question there. Do you agree with Dr. Friedman's analysis that there has been a diminishing in the average real wage over the past few years?

Dr. WOLF. Yes, but I think you have to be careful in what you infer from that. At the most aggregate level, the American economy has been growing faster than the American population. GNP has been growing over the last 10 years about 2.8 or 3 percent; the population has been growing about 1 or 1.5 percent. So per capita GNP has been increasing about 1.5 percent per year.

On the other hand, average wages——.

Chairman SASSER. That is real terms?

Dr. WOLF. In real terms, in real terms. So there is an increase in per capita GNP and there is an increase in income per capita.

Average wages have decreased because of the increased participation in the labor force that you referred to before, the two-family syndrome. Family income has increased; that is, if you look at average family income for the economy as a whole, you find that is the consequence of the higher rate of growth of GNP than the rate of growth in population.

Average wages per worker have diminished because of higher labor force participation. Consider the following example. Suppose you had a lower level of employment and higher wages per worker or, the opposite of that, a higher level of unemployment, but those who were employed were earning more. Is the latter state of the world preferable to the first alternative? It seems to me emphatically not.

We would rather have a more fully employed labor force even if the consequence of that fuller employment—because of the widened participation of less skilled members of the labor force that formerly were not in the labor force—is to lower the average wages per worker.

Over time, that will rise with the additional investment that I agree with my colleagues we need through the boosting of the American savings rate.

Dr. **Friedman**. Charlie, it is not just that we have had lots of people flooding into the labor force and, as an initial matter, they have been absorbed in low-wage jobs. The number of high-value-added jobs is shrinking.

Here we are, we are in the seventh year of the expansion and the number of manufacturing jobs is still lower, and by a good notch, than it was in 1979. High-value-added jobs are going away.

Dr. **Wolf**. There are high-value-added jobs in the services sector, too.

I commend, Senator, to your consideration an article in the current issue of Science Magazine by Bill Baumol, who was the outgoing president of the American Economic Association, on American productivity and labor force participation.

Without going into details, although I would be glad to, that picture of both the problems in the economy which we have—and I acknowledge their seriousness—but the general health of the economy, I think, is much closer to the picture that I have been trying to convey than that suggested by my colleagues.

Chairman **Sasser**. Well, thank you. Gentlemen, the hour is getting late and you have been very, very patient, but there are a couple of points that I want to cover here with you, if I could, just rapidly.

Mr. Jones, you are sort of our Wall Street representative here, I suppose, for better or worse, and I think it is for better to have you here. The Bush administration has adopted the previous administration's rosy scenario approach.

Each year, using unrealistic economic assumptions, we pretend to reach these Gramm-Rudman-Hollings targets and a year later we find we have missed the targets completely. This year, OMB estimates we are going to miss the 1989 target by about $34 billion. How do the markets perceive what is going on here?

Let me go and put this question on top of that. Yesterday, one of our colleagues here, one whom I have great respect for, Senator Johnston of Louisiana, indicated to Mr. Darman—he said, now, look, you have got $40 billion worth of phantom savings in this budget that you are bringing up here that is not going to be achieved either by way of spending cuts or the economic growth that you are projecting.

How do the markets perceive this, and what do they say about this and how does it affect them and when is it going to affect them, if ever?

Dr. **Jones**. Well, it is an excellent question, Senator. It goes back to an exchange I think I had with Senator Armstrong. The numbers game is, to some degree, being discounted in the markets for exactly the reasons suggested.

We have the rosy scenario economic forecasts. We have before our very eyes for fiscal 1989 the likelihood of a $170 billion deficit far in excess of the $136-some-odd-billion Gramm-Rudman target.

So in a sense, the markets are saying don't throw the numbers at us; throw something concrete at us. Give us a credible action either on the tax side or the spending side, or we are not going to listen.

That is much more important, by the way, in the international markets than the domestic markets, and this is where the Bush budget fell short, in my view, Senator. We don't have anything but rosy scenarios and black boxes which probably won't work in terms of freezing spending at the 1989 level for 1990 for major areas of social spending, something like $130 billion worth.

So, therefore, the answer the markets want and one of the things the markets find lacking is, is there anything that we can be pleasantly surprised at in this Bush budget. Is there anything besides smoke and mirrors, in effect, that gives us some hope for permanently cutting the Federal deficit in 1990 and beyond? And the answer to this point, I must say regretfully, is no.

So the markets are looking, finally, for either something unusual on the tax side or something hopefully unusual on the spending cuts side, or this budget will come up short in terms of market expectations.

It is no longer a question of trying to be convincing with Gramm-Rudman targets because we have just seen evidence that they are being far exceeded by actual deficits, and the only hope the Bush administration leaves us with in 1990 seems to be excessively optimistic growth figures.

Chairman SASSER. Well, now, let me just follow up. Yesterday, we were urged here in the Senate by Mr. Richard Darman to act expeditiously on the President's budget. If we didn't, interest rates were going to go up.

On the House side, before the House Budget Committee, Dr. Boskin, a respected economist, the new chairman of the CEA for the administration, was urging almost precisely the same thing.

Dr. Boskin said, quote, "If a credible deficit reduction plan is not adopted, and adopted soon, it is far less likely that interest rates will fall and the Fed will have precious little elbow room in implementing a monetary policy designed to achieve steady growth and low inflation."

Well, I think we would all agree with that. The question is do we have a credible deficit reduction plan before us from this administration?

Dr. JONES. My answer is no. There was nothing on the tax side, there was nothing on the spending side that would in any way suggest that permanent deficit reduction for 1990 and beyond is in place——

Chairman SASSER. Has the market already discounted, then, the inaction on the part of the Bush administration and the Congress on the budget deficit this year?

Dr. JONES. That is a judgment call, but all I would say is no, not fully, either in terms of how much the dollar could fall internationally or how much particularly long-term interest rates could go up domestically.

Chairman SASSER. Well, now, the administration is predicting in 1990 5.5 percent for 90-day T bills. None of you believe that is going to occur. Is that a fair assessment? Do you agree with that, Dr. Wolf?

Dr. WOLF. It sounds low, but I defer to Dr. Jones on that. I don't know what the 90-day rate currently is, as a matter of fact.

Dr. JONES. It is 8.5 percent.

Dr. WOLF. Well, that is ridiculous, then.

Dr. JONES. And I think the administration's forecast is unrealistic.

Dr. WOLF. I agree with that.

Chairman SASSER. Well, let me just ask you this. Now, when we had the 500-point crash in the stock market in 1987—and I rarely find myself in agreement with President Reagan, but I was in agreement with him on this. I don't think that was a result of Federal fiscal policy.

My own view, and this is just one man's opinion, was that it was the result of wretched excess in the markets themselves. But are we going to get any signal, in your judgment, from the markets here if we don't act on the deficit this year? And I would like to hear these other learned economists on that.

Dr. JONES. Okay, Senator, I will lead off. To me, the crash was three things. One was excesses in the market itself. Beyond any question, the price/earnings ratios and other kinds of conventional market indicators were at postwar highs and the market was ready for a downfall.

A second factor, though, was something that Dr. Friedman has made a lot of points on. That was something I would call a loss of confidence in the dollar. It was running big trade deficits, not saving enough, not investing enough, not being competitive enough. We can debate that point, but the dollar was in 1987 going through a crisis and this contributed to the stocks market crash.

Private investors were giving up on this country's ability in 1987—particularly private foreign investors—this country's ability to manage its affairs without large budget deficits, large trade deficits, and a general loss of competitiveness in the world.

Finally, the Federal Reserve blew a whistle on us at that time and said we think that inflation is beginning to get away from us and we need to do some tightening. We saw a discount rate increase prior to that crash.

All three of those factors were at work leading up to the 1987 stock market crash. The simple point is this: I would not rule out the possibility of some more financial shocks if we continue this process of being vague on what this country can do to get its house in order.

And we all agree, I think, that the solution includes increasing domestic savings, reducing the budget deficit, and increasing investment to enhance productivity and competitiveness. So I am not ruling out the possibility that some shocks will come along here. My view is the financial markets will be notable for their instability in 1989 as we go through this budget process.

The Fed will be tightening and pushing rates up. We will have rumbles on the international markets as well, perhaps. I don't see a major crisis. I don't see another stock market crash, but I do see instability in the markets ahead.

Chairman SASSER. Do you all see interest rates going up this year? Does this panel see interest rates going up this year?

Dr. FRIEDMAN. I would be more comfortable, Mr. Chairman, with a forecast of interest rates going up than one of interest rates going down. But I think it is also important to remember that, at least for the moment, interest rates are at a very, very high level compared to inflation.

Chairman SASSER. In real terms, yes.

Dr. **Friedman**. Today, the 90-day Treasury bill rate is approximately 8.5 percent. The ongoing rate of inflation is about 4.5 percent. That means a 4-percent real rate of interest on essentially risk-free 90-day paper. That is not atypical for the 1980's, but it is sure a long way from what it used to be from 1950 up until 1980.

Chairman **Sasser**. All right. They tell me that you gentlemen have got to leave for the airport, so we will bring this to a halt. I want to express my appreciation for your appearance here.

There is an enormous amount of interest in your views here in the Senate and in the Congress. Unfortunately, today you were competing with Senator Tower's hearings, a confirmation for Secretary of Energy. Mr. Darman was testifying on the administration budget on the House side, and we just simply don't have enough time to go around, unfortunately.

But you have been grand to appear here and your testimony has been very helpful. It will be read with great interest, I am confident, by the members of this committee and by others, and we very much appreciate your appearance and your testimony. Thank you.

The hearing is adjourned.

[Whereupon, at 12:30 p.m., the committee was adjourned.]

VIEWS OF THE FEDERAL RESERVE SYSTEM

TUESDAY, FEBRUARY 28, 1989

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Hollings, Exon, Simon, Sanford, Conrad, Domenici, Armstrong, Boschwitz, Symms, Grassley, Nickles, Gramm, and Bond.

Staff present: John L. Hilley, staff director; and Chuck Marr, junior economist.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

Senator Domenici, our ranking member, has been delayed, but I understand that he is in transit and on his way, and our distinguished witness this morning, Dr. Greenspan, has I am sure a very full day ahead of him after he leaves here; so I think it would be unwise and unfair to unduly delay our witness.

I want to welcome you this morning, Dr. Greenspan, before the Senate Budget Committee. Just let me say that this committee is very eager to hear your views on our current deficit situation.

Sometimes when I think I have a tough job being chairman of the Senate Budget Committee and perhaps having a tendency to feel a little self-pity, I reflect on the job that you have, Dr. Greenspan, as Chairman of the Federal Reserve Board in this very, very trying time. And I thank my lucky stars that I am not in the same slot that you are and carry the same burdens that you carry and have to be faced with the same Hobson's choices that you are faced with these days.

As it turns out, Dr. Greenspan, you are really the only policeman on the economic block, as far as I can see. With the recent action of raising the discount rate to 7 percent, and with increases in the Federal funds rate of nearly 3 percentage points in the last 12 months, I think an unmistakable message has been sent to the President and to the Congress that we had better get our fiscal affairs in order. The time is running out.

As we start the process of enacting the 1990 budget, I am afraid that the message is simply not being heard by some of us as clearly as it should. Regretfully, the 1990 budget plan which was submitted to the Congress by the administration had some serious fiscal and economic flaws, which I believe warrant your attention and your comment today, Dr. Greenspan.

The administration, for example, projects real economic growth of at least 3.2 percent for fiscal year 1990. They also project a dramatic drop in short-term interest rate which they expect to be 5.5 percent in 1990 for short-term Treasury bills.

Now, both of these economic projections are very critical to the administration's deficit projections. Indeed, the overly optimistic interest rate forecast understate net interest outlays by almost $9 billion in 1990, according to the Congressional Budget Office. And on the fiscal front, the administration proposes a budget that will yield a $95 billion deficit in 1990, but at least $10 billion of the $30 billion in deficit reduction that the administration is proposing is composed of unspecified program cuts. Some of the revenue increases that are proposed, like the capital gains tax reduction, actually loses some $23 billion between 1990 and 1993.

Now, Dr. Greenspan, these fiscal choices, in my judgment, are leading us in the wrong direction as far as deficit reduction is concerned. You have testified before this committee on previous occasions last year, and before numerous other committees of the Congress, that we must have a serious, credible, and long-term fiscal policy that will bring down the deficit. You have testified on several occasions that we simply cannot continue to finance our investment needs by continued and growing dependence on foreign capital.

I could not agree with you more on both of these points. I hope that as we continue our deficit reduction discussions with the administration that they, too, will heed your advice in that regard. We clearly need a long-term solution rather than a quick fix to our deficit reduction problem.

Now, Dr. Greenspan, your opinions count. And if anybody has any doubt about that, they should just watch how our friends in the press rush for the telephone booths out there on occasion when you make some what they perceive to be a pronouncement. Your decisions have a profound effect on our domestic economy. Indeed, they have a profound effect on the international economy. And they have a profound effect on our prospects for future growth.

So, today, I am hopeful that we can get your views on the following questions. The first question that I hope you will address yourself to is: Will you have the freedom to let interest rates move lower without significant deficit reduction?

Second, do you think we can slide by this year and wait until 1991 to forcefully address the deficit issue?

The third question: Can we realistically meet the Gramm-Rudman-Hollings targets from now through 1993 without increasing revenues at some point between now and then?

Finally, what are the likely economic consequences of adopting a 1990 budget which realistically does not represent a frontal attack on the deficit problem?

Well, I hope you can address yourself to those questions this morning, and I will defer now to our distinguished ranking member. I went ahead and got started, Senator Domenici, because they told me you were on the way and in transit, and Dr. Greenspan was waiting. So we turn it over to you now for your comments.

OPENING STATEMENT OF SENATOR DOMENICI

Senator Domenici. First, Mr. Chairman, I apologize for being late, and I thank you for your deference in your last statement. I think it was well that we get started.

Mr. Greenspan, first let me say that I am pleased to join Chairman Sasser in welcoming you this morning. You have been a longstanding friend of the Budget Committee, and you have encouraged us in the past. You have also been very understanding of the process and how difficult it is to achieve what Budget Committees in the past have recommended. So I am sure that you will understand when I express some concern about the recent increase in interest rates and just where monetary policy is headed. I think that should be part of our discussion here today.

I am going to assume in my remarks—and we will ask you specifically—that you have had an opportunity with your excellent staff to analyze the Bush budget in terms of its recommended reductions in the deficit. Having said that, I got in at the end of the distinguished chairman's statement, and, frankly, I have to disagree with what he has said.

We have to decide whether we like the priorities, whether we like the choices, whether we like the policies the President has recommended. I am more concerned about whether Congress is willing to make hard choices and do something like the Bush budget and do it quickly. I am more concerned about that than engaging in a discussion of the economics in his budget, although I would hope that you would address whether his economic assumptions are in the realm of good estimating.

I am far more concerned that we are not going to do anything because we keep focusing on what the Bush budget does not do. I think we ought to talk about what it does do. Not everyone here, not everyone in the Congress agrees with the President. I am sure if you were going to pick and choose budget options as a policymaker, you might choose other things. But I think there is a significant deficit reduction year over year, 1989 versus 1990, in the Bush budget. And I am concerned whether you think, as I do, that if we implement something like the Bush budget that it would be a significant positive step in the direction of stabilizing this American economy, stabilizing interest rates, and perhaps even taking some of the pressure off so that interest rates might come down.

That is what I am concerned about, and I think we are entitled to hear that from you. That is, unless you want to echo what some others have said and conclude that there is not enough there for you to know what is in the budget. I frankly believe, compared to any new President in office, that there is more on the table in terms of specificity than any time in the last 20 years.

We continue to say that the President has not been specific enough. This committee is not specific, in any event, and you know that. And you have anguished with us about that. When we try to be specific, we do not get the results we wanted at the end of the year. You have even said that to us in different words.

So, Mr. Greenspan, while I might not agree in toto with your assessment of the danger of inflation and what causes it and what raising the discount rate will do to ameliorate it, I think the big issue for us is for you to give us advice on whether or not something close to the Bush budget would be a good step in the right direction.

Mr. Greenspan, I say I am not sure I agree with you on causing interest rates to go up, to the extent that you are party to that. I understand you are not sure you are that big a player, but I think you are. I would just share this with you and with the members of the committee. I attended a very large meeting of the National Association of Business Economists this morning, and they have done a survey of 3,400 of their members. They reported back 10 days ago. They all made their assumptions, and they were very optimistic, all of them. Inflation will be 4.9 percent, they thought; growth, somewhere between 2.5 and 2.8 percent; and they commented that this was before the Federal Reserve took action. There was a big chuckle because everyone said if we knew what they were going to do, we might change some of these numbers.

Now, that kind of bothers me because I wonder whether or not the economy ought to be following you or whether you ought to be following the economy. I kind of wonder about that. And I have looked at the inflation rate, and I see that 25 percent to 30 percent of the increase that concerns you is attributable to such things as California raising the cigarette tax 25 cents, entertainment costs going up, medical costs going up. I guess I wonder how raising interest rates will really have an ameliorating effect on inflation if that is a significant portion of its increase.

Chairman **Sasser**. Well, thank you very much, Senator Domenici.

Dr. Greenspan, please proceed with your statement.

STATEMENT OF DR. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. **Greenspan**. Thank you. I would like to take a few minutes, however, to outline—just so we can get it on the table—what I think some of the critical issues are, and request that the full testimony be included in the record.

Chairman **Sasser**. It will be included.

Dr. **Greenspan**. It is certainly a pleasure to appear before this group this morning to discuss economic policy, in the context of the broad objectives that are relevant to both of us in our respective spheres of policymaking. I have provided our recent Monetary Policy Report and I shall avoid consuming a lot of your time discussing the details presented in that document. I believe that it would be useful, however, if I were to review briefly where the economy has been over the past year and where it appears to us to be going.

Overall, the past year has been a good one for the economy. In 1988, real GNP grew about 3.25 percent, adjusted for crop losses caused by the drought, and payroll employment rose by more than 3.5 million. The unemployment rate fell to, and then below, 5.5 percent, the lowest level since the mid-1970's, and the average manufacturing capacity utilization rate rose to the highest level since the late 1970's.

As these developments unfolded, however, it became clear that the balance of risks were shifting in the direction of higher inflation. Consequently, the Federal Open Market Committee has applied increased pressures on bank reserve positions in a series of steps beginning in the spring of 1988 and extending into this year. In addition, the discount rate was raised from 6 to 6.5 percent in August and again last week to 7 percent. Despite tightening money markets, longer-term interest rates have been relatively stable.

Some developments of the past year suggest that we still have work to do if we are to succeed in our task of achieving the goals of balanced expansion and the reduced inflation needed to sustain it. In the area of your direct interest, the Federal budget, the deficit obviously remains large. Meanwhile, private savings remain low. Continued imbalance of domestic saving and investment is mirrored in the persistent large trade and current account deficits.

In addition, although overall inflation last year—in the area of 4 to 4.5 percent—was only a little above the general range in which it had fluctuated in the mid-1980's, underlying trends were troubling. In particular, prices of consumer goods and services other than food and energy accelerated last year and this faster pace extended into January. Furthermore, some signs have emerged of greater pressures in production costs. The overall employment cost index, a comprehensive measure of hourly wage and benefit rates, rose 5 percent in 1988, up significantly from 1987. Materials inputs also were adding to costs at a rapid pace. The large increases in the producer finished goods and consumer price indexes in January could be early warnings that the cost-price process is gathering force.

At the same time, the available data for January suggest that the economy moved into 1989 with considerable upward momentum. Meanwhile, widespread inventory overhangs or constricted profit margins, which typically have signaled the last phases of expansions, are not apparent. The momentum of expansion implies risks that clearly remain on the side of accelerating inflation. It is just such an acceleration that could feed the kind of imbalances that ultimately bring expansions to an end. The Federal Reserve's earlier money market tightening and the discount rate action last week were taken to forestall such imbalances, in order to keep the economy on a more sustainable path toward price stability.

To this same end, in its plans for money and credit in 1989, the committee lowered the target range for M2 by a full percentage point to 3 to 7 percent and reduced the range of M3 by half a percentage point to 3.5 to 7.5 percent.

The Federal Reserve expects its policy in 1989 to support continued economic expansion, even while putting in place conditions for a gradual easing in the rate of inflation over time. However, in light of present conditions, the central tendency of forecasts made by members of the Federal Reserve Board and presidents of Federal Reserve Banks is for inflation to rise slightly in 1989, with the CPI edging up to the 4.5 to 5 percent range.

The central tendency of GNP forecasts for this year of Board members and Reserve Bank presidents is 2.5 to 3 percent from the fourth quarter of 1988 to the fourth quarter of 1989; abstracting from the expected rebound from last year's drought losses, real GNP is projected to grow at closer to a 2 percent rate. Net exports are likely to continue to improve as we make further progress on reducing our external imbalances, but this implies the need for counterbalancing restraint on domestic demand. With demands for labor growing more in line with expansion of the labor force, the unemployment rate is expected to remain near its recent level during the course of the year.

Looking beyond a 1-year horizon, the primary role of monetary policy in the pursuit of the goal of maximum sustainable growth is to foster price stability. Inflation in the longer term is essentially a monetary phenomenon. But large budget deficits contribute to the problem; they tend to put inordinate strains on financial markets and they directly fuel excess demand on resources. Thus, in the present circumstances, fiscal policy can help to smooth our progress over the next few years towards better price performance. Prompt and sustained action is becoming increasingly urgent.

I am mindful that, owing to significant efforts by the Executive Branch and the Congress, coupled with strong economic growth, the budget deficit has shrunk from 5 to 6 percent of GNP a few years ago to a bit over 3 percent today. Nonetheless, this share is still very large.

I am also mindful that the progress that has been made in narrowing the deficit is even greater when we look only at the so-called "primary" portion of the deficit, that is, when interest costs are removed. Growth in the interest component of the budget is volatile. It is spurred by large deficits, but it also picks up when interest rates are rising and then subsides when interest rates come down.

The most effective way to keep interest costs down is to forestall another virulent burst of inflation expectations such as we experienced a decade ago. If a 1-percentage point faster rate of inflation were to become imbedded in expectations through the financial structure, interest rates, and ultimately Federal debt interest costs, would rise by more than 10 percent from their current levels. In contrast, a 1-percent increase in the inflation rate would increase indexed programs by only 1 percent. Both fiscal and monetary policies have a role to play in preventing such a renewed bout of rising inflationary expectations.

For the longer-term, fiscal policy also has a special contribution to make in promoting growth in our production or supply capabilities. Reducing the deficit is the surest way to raise national saving, thereby lowering the average level of real interest rates, boosting domestic investment and reducing our reliance on foreign capital. The Federal deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. In the 1980's, net personal plus business saving in the United States has been about 2 percentage points lower relative to GNP than its average in the preceding three decades. Internationally, government deficits have been quite common among the major industrial countries in the 1980's, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins. In contrast, about half of private U.S. savings in the 1980's has been absorbed by the combined deficit of the Federal and State and local sectors.

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits, which must be financed regardless of the level of interest rates, tend to pull resources away from interest elastic private investment.

In the short run, the Federal Reserve can hold down nominal interest rates, but the result largely would be more inflation, with little or no lasting effect on real interest rates and the allocation of real resources. All else equal, any crowding out of productive investment damps the growth of the Nation's capital stock and the result is less capital per worker than would otherwise have been the case. This will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living.

Moreover, the higher real interest rates associated with increased borrowing by the Treasury in the 1980's have been associated with a shift in the composition of investment away from long-lived assets, such as factories, and toward computers and other short-lived equipment. Evidence points to a recent decline in the average service life of measured consumption spending as well. That is, the higher are real interest rates, the heavier is the concentration on spending that satisfies immediate desires or yields its returns quickly. Not surprisingly, we have already experienced a disturbing decline in the level of net investment relative to GNP, as depreciation has speeded up, reflecting shorter investment horizons.

Even our recent investment performance, however, may not be sustainable. The negative effects of Federal deficits on growth in the capital stock in the 1980's may have been attenuated for a while by the strength of aggregate output growth over much of the past 6 years. Such rates of output growth undoubtedly boosted sales and profit expectations and, hence, business investment, but they cannot be maintained.

Furthermore, net inflows of foreign savings in recent years have been an important addition to aggregate saving. While the Federal deficit rose by about 2.5 percentage points relative to GNP between the 1970's and the 1980's, net inflows of foreign savings have mounted, on average, to almost 2 percent of GNP—an unprecedented level—from close to zero before.

We welcome the discipline and efficiency gains of an open economy, but the continuation of inflows of foreign saving at current levels may be neither desirable nor possible. Evidence for the United States and for other major industrial countries over the last 100 years indicates that domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude, Mr. Chairman, by reiterating that the budget deficit must be brought down. The prospect of a continuing imbalance between domestic saving and investment—with the accompanying constraints on growth and modernization of capital and the substantial reliance on foreign saving—poses risks for the future. Forward looking investors may react to those risks today in financial markets. Allowing deficits to persist courts instability in the near term and threatens potentially significant reductions over time in the United States standard of living.

Thank you.

Chairman **Sasser**. Thank you very much, Dr. Greenspan.

[The prepared statement of Dr. Greenspan follows:]

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Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

February 28, 1989

Mr. Chairman, members of the Committee, it is a pleasure to appear before you this morning to discuss economic policy, in the context of the broad objectives that are relevant to both of us in our respective spheres of policy making. I have provided our recent Monetary Policy Report and I shall avoid consuming a lot of your time discussing the details presented in that document. I believe that it would be useful, however, if I were to review briefly where the economy has been over the past year and where it appears to us to be going. This may help to bring into focus the challenges that face monetary and fiscal policymakers. Principal among those challenges, in the view of the Federal Reserve, is setting the stage for sustainable, balanced growth, in part by preventing a corrosive inflationary psychology from taking hold. Fiscal as well as monetary policy has a role to play in achieving that objective, and proceeding expeditiously is much more likely to get the job done.

Overall, the past year has been a good one for the economy. In 1988, real GNP grew about 3-1/4 percent, adjusted for crop losses caused by the drought, and payroll employment rose more than 3-1/2 million. Prospects had been uncertain as the year began, given the worldwide stock market break in October 1987, but gradually, it became clear that the economic expansion remained well on track and that market confidence was on the mend. Demand for goods and services was robust, and sizable gains in employment and output pushed levels of resource utilization still higher. The unemployment rate fell to, and then below, 5-1/2 percent, the lowest level since the mid-1970s, and the average manufacturing capacity utilization rate rose to the highest level since the late 1970s. As these developments unfolded, it became clear that the balance of risks was shifting in the direction of higher inflation. Consequently, the Federal Open Market Committee has applied increased pressures on bank reserve positions, in a series of steps beginning in the spring of 1988 and extending into this year. In addition, the discount rate was raised from 6 to 6-1/2 percent in August, and again last week to 7 percent.

The policy restraint has led to an appreciable rise in short-term market interest rates. Also, growth of money has moderated, as rates on deposits lagged the rise in market rates. M2 and M3 finished the past year around the middle of their 4 to 8 percent annual target ranges, and they have grown relatively slowly in recent months.

Despite tightening money markets, longer-term interest rates have been relatively stable. Yields on Treasury bonds, for example, remained in a fairly narrow range around 9 percent for most of last year and, although rising most recently, are still not much above 9 percent. With inflation expectations apparently fairly stable and the expansion sustained, investments in the U.S. have looked attractive; the dollar's average value against major foreign currencies recovered from the late-1987 plunge and has been relatively stable for many months.

Some of the developments of the past year suggest, however, that we still have work to do if we are to succeed in our task of achieving the goals of balanced expansion and the reduced inflation needed to sustain it. In the area of your direct interest, the federal budget, the deficit remains large. Meanwhile, private saving remains low. The continued imbalance of domestic saving and investment is mirrored in the persistent large trade and current account deficits.

In addition, although overall inflation last year--in the area of 4 to 4-1/2 percent--was only a little above the general range in which it had fluctuated in the mid-1980s, underlying trends were troubling. At the consumer level, the drought boosted food price inflation in 1988, but this was more than offset in the aggregate figures by a leveling off of energy prices. Now energy prices are turning up. More fundamentally, prices of consumer goods and services other than food and energy accelerated last year and this faster pace extended into January.

Furthermore, some signs have emerged of greater pressures in production costs. Wage increases accelerated toward the end of last year. Moreover, benefits took an unusually large jump in 1988, boosted in part by a sharp rise in health insurance costs and a hike in social security taxes--both of which add to business costs as directly as do wages. Overall, the employment cost index, a comprehensive measure of hourly wage and benefit rates, rose 5 percent in 1988, up significantly from 1987. Materials inputs also were adding to costs; the producer price index for intermediate materials and supplies excluding food and energy has been rising at about a 7 percent annual pace for some time. The large increases in the producer finished goods and consumer price indexes in January could be early warnings that the cost-price process is gathering force.

At the same time, the economy generally remains vigorous. The available data for January suggest that we moved into 1989 with considerable upward momentum. Moreover, widespread inventory overhangs or constricted profit margins, which typically have signaled the last phases of expansions, are not apparent. With the economy already operating at high levels of labor and plant utilization, and given the disturbing signs of strengthening price and cost pressures, the momentum of expansion implies risks that clearly remain on the side of accelerating inflation. It is just such an acceleration that could feed the kind of imbalances that ultimately bring expansions to an end. The Federal Reserve's earlier money market tightening and the discount rate action last week were taken to forestall such imbalances in order to keep the economy on a more sustainable path toward price stability.

The same determination to resist any pickup in inflation and especially to move over time toward price stability shaped the Committee's recent decisions with respect to target or monitoring ranges for money and credit in 1989. To this end, the Committee lowered the range for M2 by a full percentage point to 3 to 7 percent and reduced the range for M3 by 1/2 percentage point to 3-1/2 to 7-1/2 percent. The Committee also lowered the monitoring range for domestic nonfinancial sector debt by 1/2 percentage point to 6-1/2 to 10-1/2 percent.

The Federal Reserve expects its policy in 1989 to support continued economic expansion, even while putting in place conditions for a gradual easing in the rate of inflation over time. However, in light of present conditions, the central tendency of forecasts made by members of the Federal Reserve Board and presidents of Federal Reserve Banks is for inflation to rise slightly in 1989, with the CPI edging up to the 4-1/2 to 5 percent range.

With restraint on inflation requiring that we limit pressures on our productive resources, some slowing in the underlying rate of growth of real GNP is expected in 1989. The central tendency of GNP forecasts for this year of Board members and Reserve Bank presidents is 2-1/2 to 3 percent from the fourth quarter of 1988 to the fourth quarter of 1989; abstracting from the expected rebound from last year's drought losses, real GNP is projected to grow at closer to a 2 percent rate. Net exports are likely to continue to improve as we make further progress on reducing our external imbalances, but this implies the need for counterbalancing restraint on domestic demand. With demands for labor growing more in line with expansion of the labor force, the unemployment rate is expected to remain near its recent level during the course of the year.

Looking beyond a one-year horizon, the primary role of monetary policy in the pursuit of the goal of maximum sustainable growth is to foster price stability. By this we mean establishing an environment where expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household financial decisions. Price stability--indeed, even preventing inflation from accelerating--requires that aggregate demand be in line with potential aggregate supply. Inflation in the longer-term is essentially a monetary phenomenon. But large budget deficits contribute to the problem; they tend to put inordinate strains on financial markets and they directly fuel excess demand on resources. Thus, in the present circumstances, fiscal policy can help to smooth our progress over the next few years toward better price performance. Prompt and sustained action is becoming increasingly urgent.

The situation today differs markedly from that of the mid-1980s, when the U.S. economy was recovering from a deep recession. Then, with utilization of labor and capital still quite low, we were able to bring these resources back into the production process at a pace that substantially exceeded their underlying growth rates. And in those circumstances, the growth of real GNP could be relatively rapid while the inflation performance was reasonably good.

But as a result of the robust expansion, the U.S. economy has absorbed much of its unused labor and capital resources. No one can say precisely which level of resource utilization marks the dividing line between accelerating and decelerating prices. However, the evidence--in the form of direct measures of prices and wages--clearly suggests that we are now in the vicinity of that line.

Thus, the thrust of both monetary and fiscal policies in the short run appropriately is more toward restraint than stimulus. The extent and duration of the financial market pressures that are likely, until overall demand moderation is achieved, will depend on the size and credibility of deficit reducing measures. In this context, credibility will be much enhanced by a multi-year approach to budget action.

I am mindful that, owing to significant efforts by the executive branch and the Congress, coupled with strong economic growth, the deficit has shrunk from 5 to 6 percent of GNP a few years ago to a bit over 3 percent today. And abstracting from the effects of economic expansion, the cyclically adjusted, or structural, deficit as a share of potential GNP has fallen by 1-1/4 percentage points from its 1986 peak. Nonetheless, at about 3 percent, this share is still very large. Since the end of World War II, the structural deficit has exceeded 3 percent of potential GNP only since 1983.

I am also mindful that the progress that has been made in narrowing the structural deficit in the past two years is even greater when we look only at the so-called "primary" portion of the deficit, that is when interest costs are removed. Interest outlays, of course, are now very large and their level will remain high as long as our stock of Treasury debt remains large. Nevertheless, growth in the interest component of the budget is volatile. It is spurred by large deficits, but it also picks up when interest rates are rising and then subsides when interest rates come down. For example, annual growth in interest costs averaged around $13 billion from 1980 to 1985, but since then has slowed to an average of about $7 billion per year.

The most effective way to keep interest costs down is to forestall another virulent burst of inflation expectations such as we experienced a decade ago. Simple arithmetic tells us that a 1 percentage point increase in actual inflation raises the cost of indexed programs by 1 percent. But if the faster rate of inflation were to become embedded in expectations throughout the financial structure, interest rates, and ultimately federal debt service costs, would rise by more than 10 percent from their current levels. We are fortunate that inflation expectations so far seem not to have worsened, and long-term interest rates have risen little in the past year despite a tightening in money markets. Both fiscal and monetary policies have a role to play in maintaining this situation.

For the longer-term, fiscal policy also has a special contribution to make in promoting growth in our production or supply capabilities. Reducing the deficit is the surest way to raise national saving, thereby lowering the average level of real interest rates, boosting domestic investment and reducing our reliance on foreign capital. The federal deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. In the 1980s, net personal plus business saving in the United States has been about 2 percentage points lower relative to GNP than its average in the preceding three decades. Internationally, government deficits have been quite common among the major industrial countries in the 1980s, but private saving rates in most of these countries have exceeded the deficits by very comfortable margins. In Japan, for example, about 15 percent of its private saving is estimated to have been absorbed by government deficits, even though the Japanese general government has been borrowing over 2-1/2 percent of its gross domestic product in the 1980s. In contrast, about half of private U.S. saving in the 1980s has been absorbed by the combined deficits of the federal and state and local sectors.

Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits, which must be financed regardless of the level of interest rates, tend to pull resources away from interest elastic private investment. When the pool of private saving is small, federal deficits and private investment tend to be forced into competition and private investment loses. To the extent that more resources are demanded than are available to be financed, interest rates will rise until sufficient excess demand is crowded out of the private sector.

In the short run, the Federal Reserve can hold down nominal interest rates but the result largely would be more inflation, with little or no lasting effect on real interest rates and the allocation of real resources. All else equal, any crowding out of productive investment damps the growth of the nation's capital stock and the result is less capital per worker than would otherwise have been the case. This will surely engender a shortfall in labor productivity growth and, with it, a shortfall in growth of the standard of living.

Moreover, the higher real interest rates associated with increased borrowing by the Treasury in the 1980s have been associated with a shift in the composition of investment away from long-lived assets, such as factories, and toward computers and other shorter-lived equipment. Evidence points to a recent decline in the average service life of measured consumption spending as well, and suggests a systematic tendency for the average service life of all spending to move inversely with real rates of interest. That is, the higher are real interest rates, the heavier is the concentration on spending that satisfies immediate desires or yields its returns quickly.

Not surprisingly, we have already experienced a disturbing decline in the level of net investment relative to GNP, as depreciation has speeded up, reflecting shorter investment horizons. Net investment has fallen to 4.7 percent of GNP in the 1980s from an average level of 6.7 percent in the 1970s and even higher in the 1960s. The effects of this decline in the net investment share has been offset, to some extent, by increased productivity of certain short-lived capital such as computers, but nonetheless, slower investment has been associated with weak productivity performance.

The U.S. net investment ratio is low, not only by our own historical standards, but by international standards as well. International comparisons of net investment should be viewed with some caution because of differences in the measurement of depreciation and in other technical details. Nevertheless, the existing data indicate that total net private and public investment as a share of gross domestic product over the period between 1980 and 1986 was lower in the United States than in any of the other major industrial countries except the United Kingdom.

Even this U.S. investment performance may not be sustainable. The negative effects of federal deficits on growth in the capital stock in the 1980s may have been attenuated for a while by the strength of aggregate output growth over much of the past six years. Such rates of output growth undoubtedly boosted sales and profit expectations and, hence, business investment, but they cannot be maintained.

Furthermore, net inflows of foreign saving in recent years have been an important addition to aggregate saving. In the 1980s, our ability to tap foreign saving has moderated the decline in the investment-GNP ratio. While the federal deficit rose by about 2-1/2 percentage points relative to GNP between the 1970s and the 1980s, net inflows of foreign saving have mounted, on average, to almost 2 percent of GNP--an unprecedented level--from close to zero before.

We welcome the discipline and efficiency gains of an open economy, but the continuation of inflows of foreign saving at current levels may be neither desirable nor possible. Evidence for the United States and for other major industrial nations over the last 100 years indicates that, for most countries, such sizable foreign net capital inflows have not persisted; hence, they may not be a reliable substitute for domestic saving on a long-term basis. In other words, domestic investment tends to be supported by domestic saving alone in the long run.

Let me conclude by reiterating that the budget deficit must be brought down. While it is beguiling to contemplate the healthy growth of recent years in the context of large budget deficits, it is fanciful to conclude that these deficits have no adverse consequences. The prospect of a continuing imbalance between domestic saving and investment--with the accompanying constraints on growth and modernization of capital and the substantial reliance on foreign saving--poses risks for the future. Forward looking investors may react to those risks today in financial markets. I do not underestimate the difficult decisions that you must make if we are to achieve the necessary reduction in the deficit. But allowing deficits to persist courts instability in the near term and threatens potentially significant reductions over time in the United States standard of living.

Chairman SASSER. I am going to be very brief in my questioning this morning because we have got good attendance, and I want to get to the other members just as rapidly as we can.

Dr. Greenspan, I understand the concerns of the Fed with regard to inflationary pressures. You look at recent evidence and see January yielded sharp increases in both the producer price index, which was up a full 1 percent, and the consumer price index, which was up 0.6 of 1 percent. Domestic capacity, certainly, according to conventional wisdom, is quite tight, running at over 84 percent.

But something that has concerned me for a number of years—and I have discussed this with you, I believe, and certainly with your predecessor, Paul Volcker—is what I sense is a tendency on the part of economists to simply look at our domestic economy and not take into consideration the overall international economy.

Now, if there is evidence in our domestic economy to concern the Fed about inflation, what about the flip side of that or expanding the horizon somewhat? What is happening internationally? The latest numbers that I have seen show consumer prices increasing at an annual rate of just one-half of 1 percent in Japan, an annual rate of about 1.5 percent in West Germany. And there is no doubt that there is excess global capacity in automobiles, in oil, in textiles—if you do not believe it, ask Senator Hollings. He has some closed textile mills in his State—shipping, agriculture. And imports are still pouring into this country.

Now, with foreign competition so fierce, it would appear to me that our U.S. producers would think twice about moving their prices up very sharply. And as one who frankly has always believed in keeping interest rates as low as possible, Dr. Greenspan, I ask you this question in that context. Do these international factors in your view reduce the risk of higher inflation here in our domestic economy? And are they being taken into consideration by the Fed?

Dr. GREENSPAN. I would say yes on both accounts, Mr. Chairman. There is no question that the integration of the international system has proceeded quite significantly in the past decade and that in part because of the fact that as we moved toward a higher degree of technologically constructed products, we find, as I have indicated previously in other fora, that there has been a very significant downsizing in the amount and the types of products we produce, and, therefore, in our ability to intermingle facilities on a worldwide basis.

There is no question—and, indeed, it shows up in the U.S. data—that the increasing capability of moving goods from abroad to the United States, and vice-versa, has created a much broader base for capacity utilization for all of the major industrial nations and, indeed, for the less developed nations as well.

When we look at the economic relationships, we do find, as you point out, that such things as concerns about competitive pressures from abroad have been keeping wage levels below what they ordinarily would have been if past history—say the 1950's or the 1960's——

Chairman SASSER. Well, that tends to wring inflation out of our economy, the international competition, with regard to wages.

Dr. **Greenspan**. But having said all of that, and looking at the fact that, our trading partners are beginning to find that their rates of operation have been rising quite significantly, and in many products, their resources are becoming somewhat constrained, what we find is that the net valuation for the United States raises, I would say, two basic issues. One is that the underlying cost structure, even making those adjustments, is beginning to show signs of acceleration. Very specifically, underlying materials prices—steel, aluminum, other intermediate materials—have been rising at about a 7-percent annual rate, pretty much steadily through 1988, but those prices did not pass through into final goods prices, largely because unit labor costs—that is, total labor cost divided by aggregate production—were rising at a very subdued rate in part reflecting the fact that external forces have been keeping them down. As a consequence, we were not getting that 7-percent increase moving through to final goods prices.

In recent months, however, as the unemployment rate has stayed down in an area where most labor economists suggest wage pressures should begin to build, we are seeing some wage acceleration—not in the manufacturing area so much, but in the service and peripheral areas. And that is beginning to feed its way through into final goods prices.

Senator Domenici is quite correct. There are a lot of elements in the January data which have no relevance to the future, and we have already made adjustments for that. We are not moving at a 7-percent or 7.2-percent annual rate of inflation. It is less.

Nonetheless, the basic problem that we are seeing is not the individual price figures as much as it is the underlying cost pressures which are evolving in the markets.

Chairman **Sasser**. Senator Domenici.

Senator **Domenici**. Thank you very much, Mr. Chairman.

Mr. Greenspan, I made a couple of assumptions in my opening remarks, and you did not have an opportunity to affirm or disaffirm them. Have you and your people at the Federal Reserve analyzed the Bush budget with reference to what he recommends by way of fiscal restraint, and reducing the expenditure side of the ledger?

Dr. **Greenspan**. Yes; we have looked at it in general.

Senator **Domenici**. Have you looked at the economic assumptions?

Dr. **Greenspan**. Yes, we have.

Senator **Domenici**. Do I read your statement correctly that with reference to the economic assumptions that you find that they are within the range of reasonable forecasting?

Dr. **Greenspan**. I certainly think that the short-term assumptions—that is, the forecasts for this year—are clearly within the range of forecasting error.

I used to be president of the National Association of Business Economists, the group you were referring to earlier.

Senator **Domenici**. Yes.

Dr. **Greenspan**. I had occasion then to look at all the forecasts that the economists made. We at the moment are probably a half a percentage point lower than the administration's forecast, but as I have said elsewhere, that is well within the range of forecasting error, and I do not find that the numbers on real growth that they have projected are outside the realm of reasonableness.

We do have some differences about the long-term potential growth rate. We are lower by maybe a half a percentage point. The administration thinks that underlying real growth is somewhat stronger than we do. I hope they are right. If we believed it, obviously we would change our numbers. But their forecast does imply that there is an acceleration from current and most recent productivity growth. We think that it is probably best to assume that that will not happen until we see it happening, rather than making that particular assumption in advance.

Senator DOMENICI. Now, Mr. Greenspan, with that foundation, you have regularly told this Committee and told Congress and told Presidents and told the American people—and you have repeated it again with all the complexities attributable to inflation expectations and interest rates and the other things—you have told us that we ought to reduce the Federal deficit as Congress' contribution to stabilizing this American economy, and I assume stabilizing interest rates, if not causing them to come down, in the future.

Is that correct?

Dr. GREENSPAN. That is correct, Senator.

Senator DOMENICI. Now, that is your statement and you say you have looked at President Bush's budget. I know you do not make judgments on policy—whether his entitlement funding is sufficient, whether defense is adequate, whether the non-discretionary accounts have been restrained too much or too little as a matter of judgment. But I ask you with reference to the overall format of reduction, assuming Congress could achieve that, would that be an acceptable and significant contribution this year?

Dr. GREENSPAN. Yes; Senator, it would.

Senator DOMENICI. Now, Mr. Greenspan, again, you hear a lot about the economic assumptions. We hear that details of the budget are not available. I am asking you as the Federal Reserve Chairman, from the macroeconomic standpoint, which is what you deal with here, do you recommend to the Congress that they act expeditiously in reducing the budget by at least the amount that President Bush has asked us to do? And if we can do it in that way, all on the expenditure side, do you recommend that as the preferred action?

Dr. GREENSPAN. I have said in many other fora, Senator, that it is crucially important that the budget deficit be reduced. And, indeed, if it is reduced in line with either the Gramm-Rudman-Hollings targets or those that are currently embodied in the President's budget message, I think that the balance that would be restored to the financial markets would be very impressive, and that interest rates would, under those conditions, I would presume, come down.

The one caveat I want to add to that is that the deficit reduction must be credible. In other words, if it is merely an agreement in which we happen to get the numbers and the bookkeeping right, but the markets do not believe it, then obviously there will not be a positive effect.

Senator DOMENICI. My last question, Mr. Greenspan. With reference to your concern about inflation, your action with reference to the discount rate, which obviously has an impact on interest rates in general, could you again for me explain your rationale. Could you tell me what would the economy have to undergo in order for your approach of letting interest rates rise work to restrain the economy? What would you want the economy to do in response to that to set things on a better path than they are now?

You have from time to time said we must invest more in plant capacity. You have from time to time said we are bucking up against full capacity. I look at that, and I see that Americans are still importing $100 billion worth of goods. I wonder if you really think we are going to get rid of that by increasing plant capacity; and if so, when.

But just in summary, what would you expect the American economy to undergo as interest rates go up to set things more right?

Dr. **Greenspan**. Well, Senator, with respect to the rise in rates to date, what we expect that this will do is to hold in check an economy which is accelerating at a rate which, in our judgment, cannot continue over the longer term. Now, I emphasize the longer term because we do not know what the short-term capacity restraints are for a number of reasons, not the least of which is that we have no real fine line which we can measure which basically says: at this point of activity, you get inflationary pressures, and at this point, you get deflationary pressures.

We do not know that in the short-run, in part because of the internationalization of the economic system. But there is no question that unless we get productivity growing significantly faster than the most recent pace, we are going to run into resource difficulties of a significant nature in the longer run. If demand continues very strongly, that means we will be pulling in large quantities of imports, worsening our trade deficit, and probably, in the process, beginning to create inflationary pressures, which ultimately will induce enough of an imbalance in the system to tilt the economy into a recession.

We do not say that those forces are now visible. And, in fact, the basic thrust of policy to date has been to keep them from emerging because I think past history very clearly indicates that if we wait for a set of imbalances to become very visible, the economic cost of reining them in will be far greater than anything we have been doing recently.

Chairman **Sasser**. Senator Hollings?

Senator **Hollings**. Thank you, Mr. Chairman.

Mr. Greenspan, I share my colleague's esteem for you; you know that. I think you are the most valuable individual we have in Government today. But you diminish and dissipate that value when you give the answer to Senator Domenici's very clever question, inferring that the Bush budget would make a significant contribution to deficit reduction this year.

How can you possibly say that when they are using interest rates of 5.5 percent, or growth of 3.4 percent, when you say growth cannot get over 2.5 percent?

Dr. **Greenspan**. Basically, because the 3.4 percent is the short-term forecast. I said earlier that I do not believe that we will achieve 3.2 percent over the longer term—we may, but I do not think it is the most probable forecast.

What I do emphasize, however, is that the deficit reduction that is implicit in that budget is, in my judgment, significant enough to have a major impact in a positive direction on the economy.

Let me just go one step further. I specifically tried in my prepared remarks to raise an important issue about budgeting and interest rates. Most countries have a concept which is the so-called "primary deficit" which eliminates interest costs as one of the mea3ures. And the reason that is done is that interest costs tend to be highly unstable. As a consequence, even though interest rates are high now by historic standards, longer term projections should not assume they will continue to be—and I hope they will not be—and if interest rates come down, that has a major impact on not only fiscal 1991 and 1992, but probably fiscal 1990 as well.

Senator HOLLINGS. Let me ask this question. Do you know of any way to get rid of the interest cost of $182 billion or the federal debt, which is $2.6 trillion; do you know of any way in the world to get rid of those two, other than by taxes?

Dr. GREENSPAN. Certainly—by bringing expenditure growth down, or preferably even——

Senator HOLLINGS. Do you think cutting expenditures is going to pay off that $182 billion in interest cost and that $2.6 billion debt?

Dr. GREENSPAN. Well, first of all, let me just say that——

Senator HOLLINGS. Let's be realistic, now. I mean, how many years? What are you talking about?

Dr. GREENSPAN. Oh, if you are talking about paying off the debt——

Senator HOLLINGS. That is right, paying off the debt and paying off those interest costs that are running at $182 billion, and growing in increments of $20 billion.

Dr. GREENSPAN. Well, Senator, the reason that the growth has been $20 billion is that interest rates have been rising. When interest rates stabilize and go down, that will fall off very considerably.

The only way to get the debt paid off—which, incidentally, I would use the figure something over $2 billion as the net figure, excluding the Government holdings of debt—but even the $2 trillion that we are dealing with can only be paid off if we run large, unified budget surpluses. I have advocated that for a long period of time and hope that that will in fact be the policy of this Government.

Senator HOLLINGS. In my limited time, let me ask it this way, then. We know the Bush budget, 26 percent is for defense, and he is asking for an increase, 4 percent inflation, or $7 billion. Entitlements are 48 percent, and he is asking for at least a $30 billion increase there. So that is a $30 billion increase for the 48 percent of entitlements, and a $7 billion increase for defense—and you have got to pay the interest, which is $13 billion.

Now, let's go to the cuts. I cannot find them. They say it is the only budget that was not "dead on arrival," but it has not arrived; I cannot catch it. That is the only reason.

But let us take the Reagan budget. He listed 82 specific items to terminate; that only amounts to $4.9 billion, and cuts of $9 billion, for a total savings of $13.9 billion. Now, if the interest costs are going up in increments of 20 billion, what does this 13.9 billion do? It certainly does not bring it down to even a balanced budget as far as what you are spending this year. We are spending over $300 billion more than we are taking in, right this minute, as you and I are speaking, and otherwise it does not bring the deficit down from the $164 billion down to $100 billion on Gramm-Rudman-Hollings.

How do you get this rationale about this being a good budget?

Dr. **Greenspan**. I was responding to the question is it a budget that, if implemented, would have a significantly positive effect on the financial markets. And the answer to that, Senator, is yes.

You are raising the question as to whether or not it is the type of budget you want to pass. That is a judgment which the Congress has got to make. All I can tell you from an economic point of view, if you look at the detail, and that is essentially what comes out in the end, is that if that turns out to be the way the budget comes out, the markets will be very favorably disposed.

Senator **Hollings**. But you know once you take taxes off the table in the rush to negotiations, that you have got to fabricate. You know that and I know that. And I remind you that the last budget summit was supposed to have brought the deficit down under Gramm-Rudman-Hollings to $136 billion this year; instead it is now $164 billion. And if you add $11 billion in cost for savings and loans, plus the excluded $6 billion on asset sales, you are running at $181 billion.

When we questioned last year, you and I together, I said the deficit was going to be nearer $186 billion than $136 billion, and I asked you to take the bet. You said you were not in the business of forecasting, and that was why you could not take the bet.

For the record, let me note that the Government is already up to a $181 billion deficit for 1989, so I am winning my bet. I cannot understand when you come up here as the most responsible official and jeopardize your credibility by embracing the platitudes and deceptions of that Bush budget. That budget is a sham.

Dr. **Greenspan**. Senator, if you gave me a pad and a pencil and said, "Write down a budget, and the Congress will pass it," I would be glad to do that. The trouble, unfortunately, is that I do not have any votes, and what I believe about what should be in what program or how the budget should be structured is a very interesting exercise by an economist, but it has absolutely no importance in the Congress and should not have.

I think that this is fundamentally a political decision in the appropriate sense of that word. I think that what the Congress has got to do with the President is make those crucial judgments about how we allocate budget resources in a manner which everyone finds satisfactory.

The only issue that I am concerned about is the bottom line—what is the deficit, what are the fundamental borrowing requirements of the United States Treasury. The rest are the major political choices of this Government, and I do not think it is appropriate for anyone other than those who are the duly elected representatives of the people to make those judgments. That is what we have got to do. I grant you it is a very difficult problem, but there is no alternative to bringing that deficit down if we want sustained prosperity.

Senator **Hollings**. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Hollings.

Senator Armstrong.

Senator Armstrong. Thank you, Mr. Chairman.

In a moment, I do have a question or two for Chairman Greenspan, but before I do so, I want to bring to your attention what probably could be called the "groundhog" concerns about the budget. We are going to hear about the economists' concerns and the interest groups' concerns, but like the groundhog, I am looking for my shadow to see when the end of winter is.

I note that, according to the committee schedule, we evidently have decided we are not even going to try to meet the statutory deadline for producing a budget in this committee. Unless I have slipped a gear here someplace, we are going to have hearings the rest of this week and hearings next week; we are going to be in adjournment for the following 2 weeks, and on April 1st, which is the date, as I understand it, that we are supposed to have a budget to the floor, we will still be in adjournment, and we return here April 3rd or 4th.

So on some occasion, I wish we could have a meeting of minds about this. In fact, my proposal would be that perhaps we have a meeting of the committee, or perhaps you and the ranking minority member could meet and give us some guidance on this. And to whatever extent it is important, or the world cares, or the Senate cares, I think we are letting everybody down by not at least trying to meet the deadline of April 1st.

It won't be long before the Appropriations Committee will want to bring some bills to the floor, and of course those will all be subject to a point of order, and it just seems to me we ought to get on with our job.

Chairman Greenspan, I want to join my colleagues in welcoming you to the committee. I congratulate you for your statement. I get the impression, partly from the tone of things this morning, and partly just from reading the papers, that most of the people with whom you are meeting or who are venturing to give you advice are telling you not to get too excited about inflation; they think you are a little more concerned about it than is really justified.

Is that pretty much accurate? Is that what people whisper to you all the time, is don't screw the economy down too tight?

Dr. Greenspan. I think I get it from both sides, Senator.

Senator Armstrong. Well, I was afraid, just from what I have been reading in the paper, that most of the people, at least in the Government, were saying to you that they did not want high interest rates, and they were willing to put up with a little inflation; and for what it is worth, I would like to weigh in on the other side.

I note with approval that you are pointing toward what you describe as a level of price changes small enough and gradual enough that they do not materially enter business and household financial decisions.

What is that level? I would have thought that was zero. Is there some other level that would do that?

Dr. Greenspan. Well, the reason I phrased it in those terms rather than a specific number is that price measurement is not accurate at the levels that we are talking about. I suspect that if the inflation rate was, say, minus two or plus one or plus one and a half, or something of that sort, on average, I do not think the average businessperson or householder would be able to tell the difference from zero.

Rather than fix on a specific number, what we are trying to do is to get inflation expectations out of the system, so it does not create a destabilizing distortion in decisions.

Zero is as good a number as any, but if somebody argued plus 1 percent or minus 1 percent, I would not want to be on the side of that argument.

Senator **Armstrong**. Well, in a most interesting way, you have anticipated my next question. There is sort of a built-in assumption around here that a decline in general price levels is virtually unthinkable, and I gather that is not unthinkable to you.

Dr. **Greenspan**. No; on the contrary, I think we have had periods in America's past where the total price level was declining, and they were periods of prosperity.

Senator **Armstrong**. Pretty much through the 19th century——

Dr. **Greenspan**. Yes.

Senator **Armstrong** [continuing]. Which also happened to be a period in which this country experienced phenomenal, really unprecedented, economic growth.

Dr. **Greenspan**. That is correct.

Senator **Armstrong**. But there is a general feeling around here that economic growth and inflation tend to go together. I am intrigued by that.

I note in some of the material that was drawn to my attention prior to your appearance that you apparently have said this before, at least to the House Banking Committee and elsewhere, it does seem to me that to aim for a price level hovering around zero, plus or minus, and understanding the imperfections in the measuring process, is a very worthy idea.

I am also conscious of the fact that when you talk, as you do on page 5 of your statement, about a CPI that edges up 4.5 to 5 percent, that that is in excess of the increase; that one former President found so terrifying that he imposed wage and price controls.

It seems to me that we have almost become complacent about price level increases year to year that formerly would have just called for drastic action. So for what it is worth, I congratulate you and hope you stick to your guns. And I hope that it does not mean a large increase in interest rates, but if it does, even that is preferable in my view toward getting this thing under control.

Dr. **Greenspan**. Thank you.

Chairman **Sasser**. Have you concluded, Senator Armstrong?

Senator **Armstrong**. I have concluded, Mr. Chairman, but I am hopeful that now, or on some appropriate occasion, you would give us some guidance on the target for the committee process.

Chairman **Sasser**. We are going to try to meet our deadlines, Senator Armstrong. We have been thrown somewhat of a curve in the sense that the Senate is going to be adjourned, as you know, for the 2 weeks leading up to April 1.

But if you feel strongly about it, I am sure we could poll the committee and see if we could get our members back here during the recess and just do our work. That would suit me fine, and I would like very much to do that.

Senator Armstrong. Could we also poll, at least as an alternative possibility, on next week? We have got 10 days, almost 2 weeks, really, before we go on recess. I could do either. I could either be available to do it next week, or I certainly can come back the week ahead of April 1st. And I do not want to be a stickler for detail, but this is not a detail. That is a pretty important obligation of this committee on which the rest of the Senate depends, and which to some extent, at least, is of interest to the world outside the Senate.

Chairman Sasser. I do agree, and perhaps we can pursue this discussion at a later date when we are not taking up the witness' time.

We are continuing to meet with Mr. Darman, as you may or may not know, during this week to try and develop more particulars on the administration's budget, and we are going to do our dead-level best to meet our April 1 deadline.

Senator Armstrong. Thank you, Mr. Chairman.

Chairman Sasser. Senator Exon?

Senator Exon. Mr. Chairman, thank you very much.

Welcome to you, Mr. Greenspan. It is always good to have you here. I have worked with you over a number of years, and I congratulate you on the firm hand that you are exercising today and your best judgment.

This morning, the fourth-quarter GNP was reported at 2 percent. This was somewhat below expectations. In your view, is this report a warning sign in any way? Does this report make the economic assumptions contained in the President's budget more or less realistic?

Dr. Greenspan. Senator, I believe the adjustments that occurred in the fourth-quarter GNP are essentially technical in the sense that additional data became available for the fourth quarter, and pluses and minuses were made.

The preliminary estimate for the fourth quarter a number of weeks ago was an increase at an annual rate of 2 percent, and the expectation of a number of analysts was that it would be increased a shade. It turned out that it was not. But I would assume that there is really no significant new economic information in there over which we need to be concerned one way or the other.

Senator Exon. So you cannot answer my question as to whether you think this makes the budget more or less realistic.

Dr. Greenspan. No; because I think they used essentially the numbers which came out this morning in their estimate for the fourth quarter in making their projections for the rest of 1989.

Senator Exon. And since you have commented some on the President's budget, do you believe that the economic assumptions for much higher GNP growth are realistic in the future?

Dr. Greenspan. Well, I think that for 1989, the forecast that they are making is clearly within the realm of a range where a lot of economists would come out. It is not our forecast. We are somewhat lower, but that is not the same thing as saying that that is an unrealistic forecast.

I do not think that economic forecasting, say, looking ahead from the end of February to the rest of the year, can come within half a percentage point easily. I would consider that if a forecast came out not far from where, for example, the administration forecast is, we would not consider that we had missed the forecast by a great deal.

Senator EXON. Mr. Greenspan, obviously during the present period, the Fed under your direction is tightening the financial screws to a considerable extent, and I assume this is because of inflation concerns. And I join Senator Armstrong in saluting you for doing what you think is necessary under the circumstances.

I am very much worried by the fact that we seem to be getting ourselves into a position where somewhere between 4 and 5 percent annual inflation rate is not too bad. The fact of the matter is—and I do not know how accurate my arithmetic is—but I think that doubles everything in about a 12- to 14-year period, something like that. That is a horrible inflation rate, it seems to me.

But is not that an inflation rate that maybe we had better be looking at in the future from the standpoint of trying to be realistic; or do you see inflation under any scenario dropping down to the plus one or minus one figure that you mentioned in response to the last questioner?

Dr. GREENSPAN. Senator, I do not think we can realistically assume that the inflation rate will stay at the current level indefinitely into the future.

I think that once you are in the realm where inflation expectations begin to affect business decisions, then there is a tendency for that actual inflation figure to accelerate. As a consequence, the reason why most economists feel uncomfortable at the inflation rate that currently prevails is not that it is doing clear, significant, corrosive harm to the economy at the moment, but that it has built into it the seeds of an acceleration which, if not dampened—if we do not endeavor to bring the current inflation rate lower over the longer-term as a policy matter—then we risk it accelerating. If it accelerates, then the effects become very damaging.

Senator EXON. Thank you. My time is about up. One last question. You talked about the perception of the markets with regard to meeting the targets set forth in the President's budget. I think there is no way of doing that. Do you really believe that there is any chance of getting down to the $100 billion target, realistically and honestly, as mandated by Gramm-Rudman-Hollings?

Dr. GREENSPAN. You mean for fiscal 1990?

Senator EXON. Yes.

Dr. GREENSPAN. No. I think the probability of actually being at $100 billion on September the 30th, 1990 is really quite small. But I would go further to say that I do not expect it to be there. However, as I have said in other committees, if after the fact, the real number is $110 or $120 billion, in that range, I would think that would be a major improvement which the markets would take very positively.

Senator EXON. Let's all wave the flag. I am telling you now it is not going to be into that area either, honestly. Therein lies the problem.

Dr. GREENSPAN. Well, Senator, I think we ought to work hard to move in that direction because if we do not get the budget deficit down within a reasonably short period of time, along a path not all that different from Gramm-Rudman-Hollings, I think that we are taking risks which we should not be taking.

Senator **Exon**. I agree with you. My time is up.

Chairman **Sasser**. Thank you, Senator Exon.

Senator Symms.

Senator **Gramm**. Excuse me. I was next, Mr. Chairman.

Chairman **Sasser**. We are following a seniority rule here, Senator Gramm.

Senator **Symms**. I yield to Senator Gramm. That is all right.

Chairman **Sasser**. All right, fine.

Senator **Symms**. I do not have any questions right now. Thank you, Mr. Chairman.

Chairman **Sasser**. Senator Gramm.

Senator **Domenici**. Senator, would you please let me explain? We are using a new rule here, and unless and until the chairman changes it, we have to follow it. I have told the chairman that for the minority, we prefer the "as you arrive, get called upon" rule; and Senator Gramm, you assumed that we could unilaterally change that in calling for the questions——

Senator **Gramm**. I am sorry, Mr. Chairman.

Senator **Domenici** [continuing]. We cannot do that until the Chairman agrees.

Senator **Gramm**. I thank the distinguished Senator from Idaho for yielding.

Chairman Greenspan, if a Member of Congress wanted to lower interest rates and strengthen and sustain the recovery, what should he do?

Dr. **Greenspan**. I guess lower the budget deficit.

Senator **Gramm**. Now let me ask you a question. We talk about lowering the budget deficit here, as we go back and forth across the aisle, as if all deficit reductions are equal, as if the economic impact of lowering the deficit by controlling spending is the same as the economic impact of lowering the deficit by raising taxes.

Let me ask you a question from the point of view of economic growth and job creation and interest rates alone—forgetting all the politics and the difficulty of it. If your objective is simply to promote economic growth and job creation, would you be better off to lower the deficit by controlling spending or by raising taxes?

Dr. **Greenspan**. By controlling spending.

Senator **Gramm**. In the law, we set out as a target—and there is no enforcement mechanism, as we are all aware—we set out the target of the Senate Budget Committee reporting the concurrent resolution on the budget by April the 1st.

Given the uncertainty in the financial markets about the deficit and about what Congress is doing, given the instability with interest rates beginning to creep up, would it promote lower interest rates and stronger growth if we in fact met that target date?

Dr. **Greenspan**. Yes, Senator, it would.

Senator **Gramm**. We have also in the law a date of April the 15th where Congress is to complete action on the concurrent budget resolution. If we adopted a budget in both Houses of Congress that met the Gramm-Rudman-Hollings targets within the constraints that we adopt the budget, and we did it on April 15th, in your opinion would it have a dramatic impact on the financial markets in terms of promoting stability, in terms of putting downward pressure on interest rates, and would it promote sustaining the economic recovery that has created 19 million new jobs?

Dr. **Greenspan**. Senator, it depends to a very large extent on whether the budget that is presented is credible to the financial markets. I must say to you I can conceive of ways in which one can meet all of the goals by fancy bookkeeping, and I would suggest that the financial markets are good accountants, and——

Senator **Gramm**. Well, let me change the question a little. Let's say we adopted a budget that was similar to, although not identical to, the budget that has been proposed by the new President.

Dr. **Greenspan**. And it had all of the potential of the type of expenditure restraint and cuts that are implicit in that, and a reduction in the deficit which parallelled that—I would say yes, it would have a significantly favorable impact on financial markets.

Senator **Gramm**. So your advice to us is to act quickly and to reduce the deficit and to do it in such a way that it is going to be real and perceived by the financial markets as being real?

Dr. **Greenspan**. I would go further, Senator, agreeing with that, but go a step further. The financial markets' view of the deficit is not solely of fiscal 1990. It is a view of the overall control of our fiscal affairs and programs in place which will not only reduce the fiscal 1990 deficit, but also have a projection of significant further decline, specifically in fiscal 1991, which is a tough year to do it, as you well know.

I would say if it is at all possible to put in place a program which clearly picks up a goodly part of the decisions that will have to be made for the fiscal 1991 Gramm-Rudman-Hollings target in fiscal 1990, I think the markets would take that rather positively.

Senator **Gramm**. And looking at the entitlement reform package in the Bush budget, would you conclude that in fact it does address the 1990 and the 1991 budget deficits?

Dr. **Greenspan**. Senator, I prefer not to comment in the very specific detail of that budget, largely because—not because I feel pro or con about it—but I just do not want to try to give you a line-by-line appraisal of what elements in it are from my personal point of view satisfactory or not, because I frankly don't think it matters what my personal view is.

Senator **Gramm**. Let me try to get my question in on the yellow light. If we simply do not act, if we go on saying we do not have enough detail, or we are not ready, or the gods are not willing, or the stars are not right, the weather is not warm enough, and we limp on along for month after month after month, what do you see as the potential for happening in the markets and in the economy?

Dr. **Greenspan**. I would prefer that that be avoided—I was going to say "at all costs," then I said to myself no, that is a little too strong, but I am not sure. I think that it is very crucial at this stage that we not let this opportunity of bringing the budget deficit down sharply slip by.

Senator **Gramm**. Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Gramm.

Senator Simon.

Senator **Simon**. Thank you, Mr. Chairman.

Since Senator Armstrong mentioned the procedure, let me just mention to my colleagues that I am going to be making a motion that, when we list interest, to put the gross interest figure where we list interest; then, down at the bottom, to list the interest in the trust funds; and second, that we separate Social Security from the whole package so that we see a bottom line without Social Security, then the final bottom line will include Social Security, so that we get an accurate appraisal of what the budget really is—because I think we are to a great extent fooling ourselves both on the interest figure and on the deficit figure. And I think it is not anything that changes the law—I would like to change the law, but it does not do that. But it gives us a little more realistic picture of what has happened.

I would like to join in commending you. I think you are one of the forces for stability in this country and for reason in this field.

Dr. Greenspan. Thank you very much, Senator.

Senator Simon. If we were a developing Nation, and you were advising us, you would say you've got to get hold of things and that is exactly what we have to do.

When you say what we do must be credible, we have got to underscore that. I think that is the reality. We just cannot play games here on either side of the aisle on this thing.

I share the concern that was expressed and that you have expressed on the inflation factor. Two of your predecessors, Arthur Burns and Paul Volcker, opposed indexing tax rates because they said they are in and of themselves inflationary.

One of the ways that we could both resist inflation and move on the deficit would be to move away from the indexation of tax rates.

CBO just gave me these figures. If we were to do this, in fiscal year 1990 we would only save $4.5 billion. But in 5 years, we would save $146 billion—no small amount. If we do it, if we eliminate indexing only for 1 year, fiscal year 1990, we would save in fiscal year 1990 $4.5 billion, but in a 5-year period we would save $53 billion.

Those are impressive numbers. My question to you is: Do you agree with Arthur Burns and Paul Volcker that indexing of rates is in and of itself inflationary; is it wise policy for us to continue that?

Dr. Greenspan. Well, first, I am not sure they would have said it is, in and of itself, inflationary, because basically what they were arguing, I would suspect, is that if inflation began to mount, then you would get a significant increase in revenues, which would prevent the budget deficit from rising inordinately.

But indexing per se is not inflationary, because essentially what it does is merely adjusts the tax take, so to speak, so that there is not an inflation premium or inflation component of tax receipts.

I have agreed with virtually all of the fiscal and monetary positions of both Chairman Burns and Chairman Volcker. This is one in which I am not with them, I have never been. I have always been in favor of tax indexing, largely because I do not like to see the issue of inflation per se creating a premium of receipts for the budget and raising the overall level of potential expenditures.

I think that—and I do not think it is a major disagreement that I would have with them—but I do not find myself completely comfortable with their position on this issue.

Senator SIMON. I think, as I recall, their argument was that when you have inflation in fact the Government ought to be absorbing money——

Dr. GREENSPAN. Reducing the deficit.

Senator SIMON. That is correct.

Dr. GREENSPAN. Yes.

Senator SIMON. Well, in any event, if we were to achieve the kind of numbers that you were talking about, $100 billion or $110 billion or $120 billion, what would happen to interest rates in this country?

Dr. GREENSPAN. If we put into place a budget which was credible to the financial community, and it was a budget which was a multiyear package which had a significant decline of the order of magnitude which you are suggesting, Senator, I think we would see real long-term interest rates fall rather significantly because it is very obvious to me that the rise in real interest rates and, of course, in the nominal rates as well, very clearly reflect the opening up of the budget deficit. If we could turn it around in a manner which looked to the financial markets as the beginning of getting rid of this excess budget deficit, I think the response would be rather marked.

Senator SIMON. Thank you.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Simon.

Senator Boschwitz.

Senator BOSCHWITZ. Mr. Chairman, I would yield to my friend, Senator Grassley, if I may.

Chairman SASSER. Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Chairman, and thank you, Senator Boschwitz.

Mr. Greenspan, before I ask some questions I would like to make a point briefly, and it is some history, that since I have been on this committee for 8 years, I have heard people in your position—I guess there have only been two in that position since I have been in the Senate—I have heard your predecessor say that each year that he was here that substantial deficit reduction would lower interest rates; and I hear you indicate that a budget agreement would help reduce interest rates, assuming it was a credible one, as you have stated. I would also note that we have had only marginal success in reducing the deficit and halting the growth of spending. And while I agree that interest rates can be influenced by the expectation of higher inflation and by many other factors, it is my belief that deficits are caused by excessive spending, and hence are the principal and underlying cause of high interest rates.

I know you do not have much disagreement with that, but I would urge you, Mr. Greenspan, as one who has an enormous amount of clout and respect among the private, as well as in the private sector, to reiterate as much and as often as possible in the coming weeks to the public, the markets and Congress that substantially lower deficits through less spending mean lower interest rates.

Now, it is obvious, as our system of grassroots representative Government works, that the public needs to hear this, and should hold our feet to the fire to get a budget agreement, to get it quickly, and then to convert that agreement into law, and I hope that you will continue to stress this point in all the appearances that you can make. You are widely quoted on that, but I think you cannot say it too often.

Now, if I could follow up where Senator Gramm left off, at least as he was trying and did get you to say—and I think from your heart—that spending reductions are better than a tax increase. Could I ask you in a very specific manner, under the Gramm-Rudman law, in your judgment, would a sequester—which obviously is going to result in a lower level of expenditure—be preferable to a tax increase?

Dr. GREENSPAN. At this stage, even though I would not like to see a sequester, short of an agreement in this committee and in the Congress, it is certainly desirable, (1) to a tax increase, and (2) especially to doing nothing.

Senator GRASSLEY. Now, does the current half percentage point uptick in inflation above its average over the past 7 years really justify from the standpoint of what you and the board have done, justify the 3 percentage point increase in the Federal funds rate over the past year? And along that line, I am really trying to find out if your goal is really to restrain inflation, or whether you have some other goals in mind, like maybe raising the value of the dollar.

Dr. GREENSPAN. No; Senator. Our primary goal is to reduce the rate of inflation in the longer term and to fend off destabilizing increases in the short run.

We would believe we would be successful if in fact inflation did not rise at all from here. Clearly, we are not in a position where we think our policy is essentially following inflationary forces. In other words, if we waited to move until after the inflationary process was clearly underway, I think we would find that the endeavor to put the inflation genie back in the bottle would be tremendously disruptive to economic processes. And the basic thrust of Federal Reserve economic policy over the past year is an endeavor to suppress the types of forces which would eventually lead to an acceleration in inflation.

Ideally, we would like to see, as a result of our actions, an inflation rate which remained subdued and in the period ahead, hopefully, worked its way down. The Federal Open Market Committee members and the presidents are projecting a somewhat higher inflation rate this year than we had last year, merely because we think there is still momentum in the economy, but our basic goal is to make sure that inflation does not accelerate and that ultimately phases down.

Senator GRASSLEY. I just want to ask you how you see your job as compared to Mr. Volcker's. Do you generally see your job as doing more fine-tuning and maybe changing policy a little more often than what Volcker did?

Dr. GREENSPAN. I do not think so, Senator. I think that we endeavor to move policy in response to the forces we perceive as occurring within the economy.

Senator **Grassley**. From the outside or looking in, do you see that you are as predictable as Volcker in the sense of how often you might change policy and how you might respond to a certain amount of bad news?

Dr. **Greenspan**. It is difficult to answer that question, Senator. It depends who is doing the predicting, really. I do not see any significant difference.

Senator **Grassley**. OK. I think you have answered my question. The only point that I would make is that if it is more fine-tuning and more policy changes, then it would seem to me you always ought to have the fear of the extent to which something is unpredictable in the financial community, that people are going to take greater protection, and that is going to lead to somewhat higher interest rates.

Dr. **Greenspan**. I would say in that respect, Senator, there are no fundamental differences that I am aware of between the monetary policy philosophy of Chairman Volcker and myself or, for that matter, the Board which he was chairman of and the Board which I am chairman of.

Senator **Grassley**. Thank you very much.

Chairman **Sasser**. Thank you, Senator Grassley.

Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

Welcome, Mr. Greenspan.

The last time you were here before the committee, you testified, as I recall, that interest rates would go down if there was credible deficit reduction. Since the time you testified, interest rates have gone up, the prime rate from about 8.5 to 11.5 percent. So I guess you would say that we must not have had credible deficit reduction. Is that correct, is that your analysis?

Dr. **Greenspan**. That is correct, Senator.

Senator **Conrad**. In that time, we have been meeting all the Gramm-Rudman targets. Would that tell you there is something wrong with the targets?

Dr. **Greenspan**. Well, no, when I say that there has not been credible reduction, what I am getting at is that we have not yet confronted the major reductions that are built into law. In other words, over the last 6 to 9 months, the economy has been expanding, and that in itself has been moving interest rates higher. The overall level of long-term interest rates has been reasonably stable—from which I infer that, overall, the markets have not yet concluded that there is a second tranche of the budget deficit decline, because remember we did have a rather significant decline from a deficit of somewhat over $220 billion down to where we are now in the range of $150 to $170 billion, and that is quite significant.

But we have not yet put in place a set of programs which the markets perceive will bring us down the next major tranche. And I think in that respect, the markets are waiting and will react, in my judgment, quite positively if there is a perception of a very significant and credible decline in the budget deficit set into law for the years fiscal 1990 through fiscal 1993.

Senator **Conrad**. I would like to retrace the same ground. You have said before if we had credible deficit reduction, we would get interest rate reductions. Instead, we have had interest rate increases. I think one would conclude we have not had credible deficit reduction. Yet we have met the goals under Gramm-Rudman.

It seems to me it is inescapable that one would conclude that the goals that are laid out in that law, or the way that law works, is not handling the problem.

Would you disagree with that?

Dr. **Greenspan**. I would disagree in part. First, there have been other forces involved in the market which have been moving interest rates higher. But if you are saying, Senator, that the legislation is not the type of legislation that one would teach as ideal in Public Finance 101, I would say most certainly not; it is not——

Senator **Conrad**. No; I am not saying in theory. I am saying in the real world, it is not working, and the evidence is interest rates are rising; the deficit has been stuck for the last 3 years at 3.3 to 3.4 percent of GNP. We are not making progress. And if one factors in the trust funds that are growing dramatically, and are used as offsets, the situation is even more serious.

In fact, if you look over the last 3 years as a percentage of GNP, when you factor in the trust funds, the deficit as a percentage of GNP is actually growing from about 5 percent to 5.7 percent.

Dr. **Greenspan**. Well, Senator, I think it is a little premature to argue that the legislative process has run into impenetrable barriers. I would certainly agree with you that the failure to get the deficit down in the last 2 or 3 years is not something which indicates that the process has been working well.

Senator **Conrad**. Couldn't you conclude that because we have not made progress in deficit reduction these last 3 years, interest rates are going up?

Dr. **Greenspan**. I would say it is perhaps part, but no, I would say that a far more important element would be the strengthening of the economy, which has been really quite marked in the last year or so.

But I would not disagree that there is some element of that in the process.

Senator **Conrad**. I will tell you, I think that is exactly the wrong message to send up here. If you do not say—what I believe to be the truth—that you are going to get reduction interest rates if you show significant deficit reduction it is going to be very hard to get this horse inside the barn.

Dr. **Greenspan**. Senator, looking at the various alternatives that are currently available, as with all the flaws that one can create for Gramm-Rudman-Hollings, I would still say to you it is the best vehicle that we've got, and I would hate very much to see us try to change it at this stage.

If you want to go back later on, after you have made some significant progress, to review how to continue, I would say fine. But I think that if at this particular point, the Congress went back and started to rethink how to construct a process which would reduce the budget deficit, I would say that is probably a mistake if our purpose is to get the deficit down.

Senator **Conrad**. I would just say in conclusion, Mr. Chairman, that whatever we are doing is not working. For 3 years, we have been stuck. And it is time to get something that works.

Chairman SASSER. Thank you, Senator Conrad.

Senator Nickles.

Senator BOSCHWITZ. Pardon me, Mr. Chairman. I believe I am next.

Senator NICKLES. Mr. Chairman, I will be happy to defer to Senator Boschwitz.

Senator BOSCHWITZ. Mr. Greenspan, I would just——

Chairman SASSER. Well, Senator Boschwitz, we are going here by seniority. Didn't you yield your time a moment ago to some other Senator?

Senator BOSCHWITZ. I did.

Chairman SASSER. Well, in that case, is Senator Nickles yielding to you?

Senator NICKLES. I will be happy to yield to Senator Boschwitz.

Chairman SASSER. All right, fine.

Senator BOSCHWITZ. I would say to my friend from North Dakota that he is incorrect about the figures. You will recall that the deficit was $221 billion in 1986, and in 1987, when spending went up just 1.4 percent, the deficit went down to $149 billion—a decline of about one-third, as I recall. And indeed, in the budget that is presented by the President, he once again seeks the same kind of very slow outlay growth, about 1.5 percent, so that we could once again duplicate the 1987 experience.

I might add that was the last time my colleague from New Mexico was the chairman of the committee. We made very remarkable strides in the budget deficit that year.

I would also like to——

Senator CONRAD. Would the Senator just yield on that point? I just want to clarify. I was talking about 1987, 1988 and 1989 as the 3 years where we have not made progress. You are quite correct on 1986.

Senator BOSCHWITZ. Well, 1987 is not 3 years ago.

Senator DOMENICI. No; 1986 was the 1987 budget.

Senator CONRAD. I am saying for fiscal year 1987, we were at 3.4 percent of GNP; 1988, 3.2 percent; 1989, 3.3 percent. So for 3 years we have been stuck. That is the only point I was making.

Senator BOSCHWITZ. However, looking at the deficit as a percentage of the gross national product, you started with the lowest year. If you go back just 1 additional year, you would find it much higher.

Senator Simon talked about the business of indexing the tax rates, and that that was somehow inflationary. It is not clear to me how that would happen. But what about indexing the budget, indexing the spending? When we spend here somewhat in excess of 20 percent of the gross national product, and much of the budget is indexed, can we truly get inflation in hand as long as that continues?

Dr. GREENSPAN. Well, Senator, what indexing the expenditure side clearly does is protect the real level of expenditure. Obviously, if the basic purpose is to get the nominal outlays to grow much more slowly, then you have got to consider the fact that if all programs in the budget are somehow indexed, you cannot get a rise in nominal outlays less than the inflation rate, and therefore you will not be able to get control.

Senator BOSCHWITZ. It has an impact on inflation, obviously.

Dr. GREENSPAN. Certainly, yes.

Senator BOSCHWITZ. Regretfully around here, we take so-called current services and take a new figure that reflects an increase for inflation plus other increases under current law and then start bargaining from this new higher figure. We should rather begin with the figure of expenditures for the current year, and I hope we will make that.

I note, too, and I would say to the chairman of the committee, that the Bush budget is $1.16 trillion. Most of that is defined. The so-called "black box" that you have talked about, is about $136 billion of the total; the rest of it, well over $1 trillion, is defined by the President, and he has done quite a bit more than his predecessors, President Reagan, President Carter, and even President Nixon. We looked back at those things.

I might say to the President that I share Senator Armstrong's view that we ought to get going. As I look at the chronology of the first Reagan budget, I note that he came in and inherited a budget from the Carter years of about half the present size—about $700 billion, as I recall—and we had a reconciliation bill pretty much underway by this time. I hope that we will be able to make the April 1st deadline and move from hearings to the budget. That, I think, would have some of the positive impact that Mr. Greenspan is talking about.

Let me ask you also, if we don't address the budget, and deliberations drag on through the spring and summer, do you anticipate that there will be greater pressures on interest rates?

Dr. GREENSPAN. Senator, I just do not think we ought to be taking the risks that we may get financial disturbances if it is perceived by the markets that the Congress is deadlocked with the administration and that no progress is being made.

I cannot forecast precisely what will happen under those conditions. It is just that there occur on occasion certain types of events which we would just as soon did not happen. I think that we cannot afford to take risks. We may get away with it; I do not know, but I do not think it is desirable to even contemplate not coming to a conclusion on this issue.

Senator BOSCHWITZ. Well, I would address a question, then, to the chairman, as I look back at the chronology of the first Reagan budget, which ended up in a rather large reconciliation bill, whether or not he anticipates that we are going to be able to meet the statutory schedule of April 1st. Indeed, I think that by April 15th we are supposed to have concluded the conference. I recognize we have a couple weeks of recess, and it is probably unrealistic to say we are going to hold meetings throughout that. But I would hope that we would move with great dispatch and make the April 1st deadline. I think it can be done.

Most of the budget has been defined by the President. The "black box," as you say, is approximately 10 percent of the budget and fairly well-defined, anyway.

Chairman SASSER. Senator Boschwitz, your time has expired.

I might say with regard to the "black box", when you take Social Security and interest off the table, the "black box" amounts to 40 percent of the remaining budget. Now, what we are called upon to do is make fully one-third of the savings out of the so-called "black box." I might also say that the budget is not clearly defined with regard to the defense component, either. We found that out yesterday, Senator Grassley and I, holding hearings in the Military Construction Appropriations Subcommittee, and I suspect the Defense Appropriations Subcommittee is finding the same thing, if I am not mistaken.

I am going to yield my turn here, in an effort to move us down the line——

Senator Boschwitz. I wonder if you would address the question about April 1st, Mr. Chairman.

Chairman Sasser. Well, I have already answered that, Senator Boschwitz. I have said we are going to make every possible effort to meet the statutory deadlines that are imposed upon us by the Budget Act. I think I answered that question when you were out of the room a moment ago; it was asked by Senator Armstrong.

We will next move to Senator Bond.

Senator Bond. I yield to Senator Nickles.

Senator Nickles. Thank you, Senator Bond.

Mr. Chairman, thank you.

Chairman Greenspan, I might come from a little different perspective than that of Senator Armstrong and others. I am very concerned about the rise in interest rates, and I for one have never adhered to the philosophy that the best way to eliminate inflation is by increasing interest rates and therefore cooling off the economy through a controlled or squeezed recession, or by increasing the cost of money as being the proper way to handle inflation.

I am also very concerned about the impact on recent actions that the Fed has taken and what that will do to the deficit. I asked staff to prepare a statement of why the deficit has increased from the October 15th budget estimate, and for the fiscal year we are in right now, 1989, it was $146 billion. In February, OMB estimated it to be $163 billion. That is a $17 billion increase in the deficit. I asked for a breakdown, and $11 billion of that $17 billion was through increased interest expense.

So we see that interest costs have a very direct and a very immediate influence on the deficit. OMB estimates that next year, interest rate on 90-day Treasury bills will be 5.5 percent. They are at 9 percent today, or close to 9 percent.

Dr. Greenspan. A little under.

Senator Nickles. Well, let's say 9 percent for ease of calculation, 3.5 points, or if they continue to escalate, 9 percent might be a better guesstimate of what they would be. That would increase the deficit according to my calculation, for next year alone, in interest expense alone, about $50 billion.

Would that be a correct assumption?

Dr. Greenspan. I do not believe so, Senator. The interest payment does not rise or fall exactly with the Treasury bill rate. That is only part of the overall payment.

It is certainly true that if interest rates stayed where they are and continued into the future, that you would have significant effects down the line. But remember that what it amounts to is, over the long run, a 1 percentage point increase in the cost of carrying the debt is equal to about $20 billion annually in interest payments.

The point I would like to make and the point that I think is relevant here is that in the event that the pressures come off the economy, and the inflationary pressures begin to ease, as they invariably will at some point, interest rates will move lower, and interest costs will be basically reflective of more average interest rates over time.

Senator NICKLES. Let me interrupt if I might. I have just been looking at the Federal funds rates that we have had throughout this decade. In the period starting in 1979, 1980, 1981, and in the middle of 1982, we had very high interest rates, and we also had a high inflation. And correct me if I am wrong, but it is my assumption that the Fed greatly increased interest rates to break the back of inflation.

Dr. GREENSPAN. That is essentially correct. What they were doing was trying to slow the growth in credit aggregates, and in the process, interest rates rose. It is the slowing of credit and money growth which ultimately brings inflation under control.

Senator NICKLES. Well, I am not sure I totally agree with that answer. But I am really concerned about the results, because if you look at the net deficit that we ended up—we had a great increase in the deficit in the period of 1982 and 1983 because of the slowdown in the economy, and I am concerned that you may be doing the same thing right now; that by the increases of interest, by constricting the amount of money—and I looked at monetary supply for the last 13 weeks, and M1 was basically zero, M2 and M3 were 2.7 percent and 3.9 percent; M2 was below the forecasted range of 3 to 7 percent, and M3 was at the very low end of 3.5 to 7.5 percent for the guesstimate—but my concern is that maybe overdoing it, constricting monetary supply, driving the cost of money up, having two net impacts—one, greatly increasing the deficit for the year that we are in right now, and also greatly increasing the deficit for next year, and in addition to that, putting enough downward pressure on the economy that will decrease the revenues and exacerbate significantly the economy's problems as well as our budgetary problems.

Now, I know you have a difficult job. But I for one wanted to make sure that you would hear another voice in the wilderness saying wait a minute, I am concerned that maybe you all are going in a larger direction toward increasing the cost of money to cool off the economy, and it may greatly increase the deficit problems and economic problems we have in this country.

Dr. GREENSPAN. Senator, the concerns that you show are concerns that all of us who are involved in monetary policy talk about. In other words, if you were to sit in on numbers of different meetings, you would hear that many of the concerns that you have expressed are put forth.

Our concern, if we looked at it in what is the consensus of the Open Market Committee, is that we do not want to see interest rates rise through an inflationary set of pressures, which would then tilt the economy into a serious recession. It is our view that the policies we have put in place are likely to create a lower level of interest rates in this particular period than would otherwise occur if inflation began to accelerate.

So our fundamental purpose is essentially to try to maintain stability in the economy. The way we perceive of balancing the various risks—and there are risks, we are not denying that—is that the risks are very substantially, looking at all of the evidence and all of the data that we can look at, at this stage more in the direction of inflation than they are in terms of recession. We hope and believe that the policies we have implemented will bring us to a much more sustainable economic expansion. In the event that we get a recession somewhere down the road, and we think that the business cycle has not been cured, that appropriate policies at this stage will assure that that recession, when it occurs, will be mild.

Senator **Nickles**. I am afraid you are laying the seeds for that recession. I wanted to raise that with you, and I appreciate it.

Dr. **Greenspan**. We certainly hope not, Senator. We hope we are doing the opposite.

Senator **Nickles**. I hope not, too.

Chairman **Sasser**. Thank you, Senator Nickles. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

Chairman Greenspan, it is a pleasure to discuss these issues with you again in the Budget Committee as we have in the Banking Committee. You have not been before the Agriculture Committee yet this year, but maybe we can see you there as well.

But I know my senior colleagues on this committee have been very much interested in the question of interest rates, and you have addressed that at page 7 of your prepared remarks. But I was noticing that interest expense in the budget in fiscal year 1981 was about $69 billion, and for fiscal year 1990 will be about $173 billion. And now that interest rates are going up again, the cost associated with the higher rates is going to be felt throughout the budget; it is going to increase the cost of the FSLIC bailout, and it is going to make our efforts to meet the Gramm-Rudman deficit reduction targets even more difficult.

Could you discuss how we can get out of this quandary where the one thing that is needed to cure rising interest rates is made more difficult by rising interest rates?

Dr. **Greenspan**. Senator, as I indicated to Senator Nickles, we view the policies that we have been implementing as creating a path of average interest rates which is likely to be lower than it would be had our policies not been implemented.

It is difficult to simulate how an economy so complex as ours would have behaved if, for example, we did not start the tightening process in the spring of 1988. But I think there is a very good case to be made that at this stage, we would find that long-term interest rates were almost surely much higher than they are at the moment, and it is probably even the case for short-term rates as well.

It is our expectation that by suppressing inflationary forces, over the long run we keep interest rates lower than they would otherwise have been, especially real interest rates, but I would suspect nominal interest rates as well.

I do not think at this particular stage that we have the option, granted the underlying strength of a very powerful and I would say a rather successful economic expansion, of having both this continued state of prosperity and significantly lower interest rates.

Senator **Bond**. Mr. Chairman, just to go through some of the areas that you have already addressed, we have had lots of questions this morning, and I want to make sure that my understanding is correct. You are saying that markets are jittery, really, because both the Fed and the markets themselves are watching what we do in Congress, and that Congress really has not done a good job of making meaningful budget reductions yet. Is that fair?

Dr. **Greenspan**. I certainly would not say that we are looking in the sense that our actions are in any way related to what the Congress is doing. But it is certainly the case that the financial markets are watching very closely what will come out of these budget discussions and negotiations. I am acutely aware on a day-by-day basis of market movements both here and abroad being determined by changing expectations—rightly or wrongly, incidentally—about what is in fact occurring in these budget negotiations.

It is perfectly clear to me that should these negotiations proceed in an effective manner and produce significant multiyear credible reductions in the budget deficit, that we will see some very, very favorable responses in the marketplace.

Senator **Bond**. And may I assume from that that you would also say that the timing has something to do with them, that the longer we delay, the longer they will be jittery or in turmoil, and that on the other hand, if we were to act quickly, this would send a meaningful signal that would be reflected much more promptly?

Dr. **Greenspan**. I do not think there is any question about that, Senator.

Senator **Bond**. And furthermore, that missing the Budget Act targets is a signal going in the wrong direction?

Dr. **Greenspan**. Most certainly.

Senator **Bond**. Well, Chairman Greenspan, you have confirmed our fear that congressional inaction will keep interest rates high for home mortgages and others, and as the deadlines go by and markets become even more jittery, in my view, the Fed will probably have no choice but to continue on its present course. And Congress is not going to be in a position to argue that it does not know the economy is waiting for positive action; rather, irresponsible inaction is going to have to be blamed if interest rates continue to go up through the spring and summer.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you very much, Senator Bond.

Senator Symms.

Senator **Symms**. Thank you very much, Mr. Chairman.

Chairman Greenspan, welcome to the committee. I have had a chance to peruse your comments, and as you know from some personal conversations, I have had some concerns similar to those Senator Nickles brought up about the relationship of interest rates to the growth of the economy. If you were to have to use the word "neutral," "tight" or "loose" to describe current monetary policy at the Fed, which do you think best characterizes the policy that you and the Fed Board are following now, in terms of monetary policy—or would you choose none of the above?

Dr. Greenspan. The trouble is that the words are often very fuzzy. What some people would consider to be tight money, others would consider to be not tight enough, or loose. I think you will find in the marketplace a fairly broad spectrum of opinion which would interpret Fed policy as being not tight enough to too tight. And there may even be some out there who are saying we are too easy.

Senator Symms. Well, one of the things that troubles me, sitting here as a member of the Congress, is that sometimes the Congress as a group just fails to see reality. If the sidewalk is wet, and it is raining outside, they think the reason it is raining is because the sidewalk is wet. What concerns me about this whole budget process is that the fastest growth in the budget has been in the non-defense area for fiscal years 1985, 1988 and 1989. And yet there is a perception the budget was cut.

The Reagan budget plan that came over previous to this current budget identified 82 programs that might be terminated—that are not as important as some of the other programs; yet we never can seem to muster up the strength around here even to reduce some of those.

Just to give you an example, the last time we had a meeting—I forget who was here, testifying—it was last week in this committee, I made the observation that we seem to be able to dig up enough money to put radios on grizzly bears and have two or three people to track them, and then when the bear dies, they have to go find another bear and put another radio on it, and I said the next thing will probably be wolves. And sure enough, yesterday I had a man in my office who was on his way out to my part of the world to do the same thing with wolves now. This is an expensive program; it is in the hundreds of thousands of dollars, just to do a study on this. Yet we sit here and talk as if we "cannot" cut spending.

So it leads me back to the question I want to ask you, and that is another multiple choice question. If we have an approximately $100 billion deficit under our current projections, and let's say we get in the ball park of that number plus or minus $20 billion, that is a $1.15 trillion budget. Everybody in here talks about balancing the budget, as though it is the most urgent thing in the world, and I have to admit I am troubled by the debt that we are piling up—but mostly I am troubled by how much the Government spends, I think, more than any other factor. Would the markets respond better if Congress had a $1.25 trillion budget rather than a $1.15 trillion budget, but had the budget balanced? Would the financial markets react better or worse to that? Are they just focusing on the deficit, or are they focusing on the underlying problem of the government spending so much money on programs that are questionable?

Dr. Greenspan. I think, Senator, that the markets are focusing on the budget process which creates deficits, creates financing requirements and the like. I cannot comment on your specific example because it is difficult to make a judgment at that level. But there is no question that the multiyear pattern of deficits is crucial, and how the Congress and the administration comes at developing the budget is not irrelevant to the way the markets behave, because if, for whatever reasons, we ended up with a significant short-term reduction in the budget deficit, but the markets or the players within the markets, perceived that the process was going to create a turn-back-up of the deficit within a short period of time, I would think that the markets would react negatively to that.

Senator SYMMS. Thank you. If I can, I just wanted to ask you to make one other comment that I think is relevant to the markets.

The markets, I would assume, watch the vagaries of the so-called surplus that are piling up in trust funds, and which really are not there. Would you say that is a fair statement?

Dr. GREENSPAN. Well, I would say that the markets look at the net financing requirements of the United States Government and, in that sense, look at the financing of the unified budget more than the components——

Senator SYMMS. That is what I mean—but at some point in time, don't you think the markets, as the years roll on—and my time has expired, and I apologize; if I could just finish this question. Maybe you could comment—as the years roll on, and we get closer to the point of the baby boomers' retirement and those people discover that we have already spent this money, watching the wolves and the bears and whatever else the government thinks is necessary, be it B-2 bombers or whatever they spent the money on, how serious do you think it will be for our economy when Congress has to raise taxes to replace the money?

Dr. GREENSPAN. I think budget analysts will recognize that the financing of benefits over the long run will imply a budget deficit or Federal borrowing, perhaps. If they conclude that, then clearly that would be negative.

Senator SYMMS. I thank you.

Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Symms.

Dr. Greenspan, following up on some questions that were asked you a little earlier today, are you telling the Committee this morning that the OMB current services deficit projection for fiscal year 1990 is a credible projection, and are you telling us that if we reduce that $127 billion current services deficit projection of OMB down to meet the $100 billion Gramm-Rudman-Hollings targets, that that is all the Fed and all the markets want to see this year?

Dr. GREENSPAN. I am saying it is a very important first step, Mr. Chairman. The issue is not so much or not solely fiscal 1990, but fiscal 1991 and 1992 as well.

To the extent that the reductions that you might create to bring fiscal 1990 to the $100 billion target and those actions are also clearly cutting the deficit in 1991 so that we do not have to go through this whole pattern again, I think the markets will take that rather positively.

Remember that what cannot have a positive effect is finding some set of bookkeeping gimmicks which largely meet Gramm-Rudman for fiscal 1990 and then paper over 1991, 1992, 1993 in a budget resolution now. If that happens, then I think the markets will take it negatively.

If, however, in the process of meeting the fiscal 1990 numbers, there are credible programmatic changes which suggest that the cuts that are required for fiscal 1991 are well underway and taken by the actions involved in the fiscal 1990 resolution, I think that would be quite positive.

Chairman SASSER. Dr. Greenspan, I do not need to remind you, that yesterday 90-day Treasury bills were at 8.7 percent, and OMB projects interest rates of 5.5 percent for 90-day T-bills in 1990.

Are you telling us that you realistically expect interest rates to decline to 5.5 percent if we enact the savings that are in the Bush budget? That is a mighty big carrot to hold out there, and a lot of people would find that very appealing.

Dr. GREENSPAN. The problem that exists in budgeting in this country is that, unlike a parliamentary system where the prime minister can promulgate a budget and implement it immediately, and therefore make economic assumptions which are consistent with that budget package, we cannot.

What in fact the President is essentially required to do is to make economic assumptions which presuppose that the Congress passes all of his individual programs and policies. And I do not think there is any question that should you get the type of sharp reduction that is implicit in the budget deficit projections of the Administration, that there will be a significant decline in interest rates. The market will bring interest rates down.

Now, the question as to whether in fact that will happen will depend essentially on whether the programs are put in place. But if what is put in place is a program which meets fiscal 1990 and papers over fiscal 1991, 1992 and 1993 so that the resolution is effectively really not credible as major budget reduction, then I do not think interest rates will fall. What is implicit in the President's budget is in fact a significant slowing in Federal outlays, and even if you alter the revenue side on the grounds that one may want to change some of the longer-term economic potentials, you still get a very significant decline in the real budget deficit, enough to have, I would say, perceptible, rather major impacts on interest rates.

Chairman SASSER. Well, in the business of economic forecasting here, you say that the President and the Administration rely on Congress adopting the proposals that they have laid out. Now, in the real world, we know that does not happen. If you look back over history, historically, Congresses make changes.

Now, given the gravity of the situation here, Dr. Greenspan, wouldn't it be more prudent to rely on economic assumptions that err on the conservative side as opposed to economic assumptions that err on what I perceive, and I think what most economists that I have talked to believe err on the optimistic if not the euphoric side of the equation. We are talking about 3.5 percent real growth in GNP, 5.5 percent interest rates, at a time when the Fed appears to be saying, look, we think this economy is in danger of overheating, and we are not going to let this economy grow by 3.5 percent. We think maybe 2 or 2.5 percent is going to be the tops it can grow with this capacity.

Shouldn't more cautious economic assumptions be used?

Dr. GREENSPAN. Over the longer run, which means a 4- or 5-year time frame.

Mr. Chairman, let me just make one point here which I think is relevant to this discussion. The answer is would I, if I were making the estimates, be somewhat more cautious in some of the forecasts—yes, probably, I would.

Chairman SASSER. But you have been more cautious in your forecasts.

Dr. GREENSPAN. Yes; but I think you have to recognize that economic assumptions are not what this is all about because, irrespective of the economic assumptions that one put into the President's budget, if one introduced a significant slowing in the rate of nominal budget outlays, we may not get the $100 billion in fiscal 1990—almost surely would not. We may not get a budget surplus in fiscal 1993. But we would get a significant reduction in the path of the budget deficit, and while I may say I would like to see the Gramm-Rudman-Hollings budget deficit targets met literally each year after the fact, I do not think that is required to bring a significant reduction in interest rates.

As I said earlier, if, for example, after the fact, in, say, early October 1990, we looked back, and we said we had a $115 billion deficit in fiscal 1990, I think that is a major improvement, and I think the markets would be very importantly affected by that.

Chairman SASSER. Well, as I understand what you are saying, Dr. Greenspan, is that it does not make a lot of difference whether we take OMB's current services deficit or CBO's current services deficit, even though there is a $20 billion difference between the two; the important factor here is that we continue a downward glide path for the deficit, and if there is a $15 or $20 or $25 billion discrepancy, that is really not the important factor.

Dr. GREENSPAN. Well, let me just amend my remarks slightly. If it is a very gradual decline, I would say it probably would be inadequate. However, even if attaining a budget surplus is delayed by a year or two in the end that is nowhere near as important a problem as taking big chunks out of the deficit each year thereby making certain that we get on a path of outlays which will get us somewhere in that range.

What I am really saying, Mr. Chairman, is that the forecasts, while not irrelevant, are not the crucial issue here. The crucial issue is that the expenditure path be such that it projects enough of a decline, under anybody's assumptions, in the deficit so that the financial community will feel that the pressures on our markets will ease. And it is not going to matter whether or not there is $10 or $15 or $20 billion difference between the forecast and actual deficit. It will certainly matter if the process stalls. If we reach $115 billion in the real world, not on paper and say, $90 billion, just as a number out of the dark, for fiscal 1991, when the numbers are all in—that is a major improvement. I think that would be the type of thing we should be focusing on.

Chairman SASSER. Let me take you back to one other statement you made earlier. In response to one of Senator Grassley's questions—and Senator Grassley has a way of cutting through the underbrush and getting to the meat of the coconut on occasion—but in response to one of his questions as I understood it, you indicated that you thought sequester would be preferable to a tax increase if we could not meet the Gramm-Rudman-Hollings targets without a tax increase.

Now, Dr. Greenspan, that sounds suspiciously like a policy judgment to me, and you indicated earlier today that you were not in the business of making policy judgments. But in fact what you are telling this committee if I understood you correctly—and please correct me if I did misunderstand—was that you would prefer a $13 billion cut in the defense budget, which is what sequester would do, to the Congress raising taxes to meet the Gramm-Rudman-Hollings targets.

Dr. GREENSPAN. Well, Mr. Chairman, the reason I indicated the answer the way I did is that I have stated previously when I was a private citizen that I would prefer sequester under those conditions, not basically because I think it is a good idea—I think it is a terrible way to run the budget; in fact, the consequences are really quite unacceptable, as far as I am concerned. But I do think it is terribly important for us to communicate to the financial markets that the budget process, the Gramm-Rudman process, is for real, and that in effect we are willing to take what is a very painful cut and I think, frankly, an inappropriate way to come at these particular processes.

Chairman SASSER. But rather than raising taxes to get to the targets, if you had to make that difficult choice—and you are in the business now of making very, very difficult choices, and I said earlier I do not envy you—you would choose the sequester route, which would reduce about $13 billion in defense spending and $26 billion in defense budget authority here in this fiscal year 1990 budget.

We might be able to do some business on that basis, Senator Domenici.

Senator DOMENICI. Who is "we"? Are you speaking for your side of the aisle?

Chairman SASSER. Ourselves and the administration.

I just want to be sure, Mr. Chairman, that I did understand——

Dr. GREENSPAN. That is correct, Mr. Chairman. I am not advocating it by any means, because I think there are lots of problems with sequester, many of which we have not really discussed at length.

Chairman SASSER. That is true.

Dr. GREENSPAN. But I think it is so crucial that it not be perceived that we are backing off deficit reduction, that that is the least worst of the alternatives that I see.

Chairman SASSER. One final question, and I will defer to my distinguished colleague, Senator Domenici.

Dr. Greenspan, I have long been concerned about the decline of the savings rate here in the United States. I am principally concerned about it because, with the large budget deficits the Federal Government is running, with the competition for capital in our economy and the lack of savings on the part of our people, we are going abroad for a very, very substantial portion of the capital that we use to finance our economy and also to finance our national debt.

In reading your testimony before another committee the other day, you made the statement that, "domestic investment tends to be in the final analysis supported by domestic savings alone"—indicating that we could not continue to rely on foreign savings to finance the operations partially of the Federal Government, nor to finance partially the investment in our domestic economy.

Do you have any recommendations as to what this Congress could do, or what could be done, to encourage savings on the part of the American people?

I fear on occasion we are simply dealing with a cultural quirk here, and perhaps it is something that is beyond the control of Government or others.

Dr. **Greenspan**. Well, Mr. Chairman, I certainly hope not, because in one sense, even though clearly the budget problems that confront us are our number one priority as I see it at this particular stage, if we look beyond the budget issue to what is the major economic problem that this country has, I think it is the fact that our domestic savings are inadequate to meet the type of growth and the type of priorities that the American people have.

The Secretary of the Treasury is acutely aware of this problem, and when they and we get beyond the thrift crisis problem and a number of other things, there will be endeavors to look more closely at this issue, I would hope that a number of us who have been seriously concerned about the deficiency of savings in the system will be able to present to the Congress some useful recommendations to perhaps alter that trend, which I find very troublesome.

Chairman **Sasser**. Senator Domenici.

Senator **Domenici**. Thank you very much, Mr. Chairman.

Mr. Greenspan, the Chairman and others raised the question of short-term interest rates in the Bush budget versus history. And while I am not sure whether they are right or wrong, I am not sure where interest rates will be in the future. Just to show you how volatile they are and how wrong people can be, I would like to note that short-term T-bill rates on February 24, 1988 were 5.62 percent. I only state that because that is not a long time ago. I am saying that if things go right not a long time from now, interest rates could be back where they were. I am not sure of that, either, but I merely cite the number because it seems to me to have some historic relevance.

Mr. Chairman and Mr. Greenspan, let me suggest that there have been a lot of numbers bantered around here as to what President Bush's budget does and what it does not do. I personally want to commend you for suggesting to this committee that if we do something similar to that budget that we have made a very significant dent in the deficit. And I want to give you a few numbers for the record, because my good friend Senator Hollings comes at it another way. It looks altogether different if you compare the numbers year over year. So I would like to read those, because I think your conclusion is right. I am not sure Congress will do this, but here are the numbers.

In the Bush budget defense outlays go up (1989 over 1990) seven-tenths of 1 percent. The discretionary accounts, all of them, those that go up plus those that are frozen, go up 3 percent. And interestingly enough, the total of entitlements and mandatory that are non-Social Security go up 0.5 percent, five-tenths of 1 percent, and Social Security goes up 9.3 percent. But year over year, the sum total of those goes down 9.7 percent.

Now, I think that is precisely what you have been telling us, if we establish some significant trend lines in the direction of outyear control of this budget, you have been telling us that would have an impact, is that correct?

Dr. GREENSPAN. That is correct, Senator.

Senator DOMENICI. And you are not talking about a specific budget; you are talking about something implemented at the end of the year, if I understand you correctly—done, completed, operative.

Dr. GREENSPAN. Yes.

Senator DOMENICI. Now, Mr. Greenspan, having said all of that, I want to close this hearing from my standpoint with a very, very genuine concern.

I asked my first round of questions trying to get to the fiscal policy versus the rest of the American economy and the Federal Reserve's role in it. But I seriously want to say, number one, I commend you for trying to walk a tightrope—and you have stated over and over here that what you are really trying to do by tightening money is to have the interest rates over a period of time be less than they would otherwise be. Number two, if I read you correctly, you are very concerned about inflation, and you are concerned about America's capability to produce significant enough growth in the economy to avoid inflation. And you want to do your share in trying to solve that, as I understand it. Is that fair enough?

Dr. GREENSPAN. Yes.

Senator DOMENICI. Now, Mr. Greenspan, I am firmly convinced that not only your national board, but those regional banks out there do not understand the impact of their decisions and their suggestions on the American people and the American economy. And I really believe somebody ought to tell them, because I think before we choose, we ought to know what we are doing.

And my closing remarks are that I am firmly convinced that none of the good things that the Federal Reserve Board thinks they can do with this economy, including sustained reduction of inflation by their actions, increasing our productivity over the long run, reducing our dependence upon foreign trade can be done without dramatically punishing the American people. And I really mean that.

I believe when you finish analyzing this, you will see that you will not get appreciably good results without far more ratcheting down than you currently want to do. And I am convinced that before you squeeze stuff out of this economy from your side, you have got to almost be a self-fulfilling prophet and cause a recession.

You do not want that, and you are not going to try to do that, but I am convinced you cannot accomplish what you want with these little niches like you all think. I think it is going to be ineffective; inflation is not going to respond, and to make it respond, you have got to do dramatic things.

That is one Senator speaking. I do not have any power with reference to the monetary system. You are independent, and you ought to be. But I am concerned.

Now, what do we do about it? I only have a suggestion that maybe—maybe—you ought to be very, very forthright if you can with the President and the Congress and the people. And today you have tried because you have said "please reduce the budget deficit, please reduce it." But I think that might not be enough, because there are people out there within the Federal Reserve system who are on some kind of mission. They are even out there advocating zero inflation in those regional banks; they are gung-ho, and that sounds neat—but we ought to know what the medicine is, and conversely, Dr. Greenspan, we ought to know what alternatives we have. It may not be enough just to reduce the deficit. And if that is the case, we ought to know it.

I close by saying I am not sure what a "business cycle" is, but that is what we are talking about—getting near the end of one of these sustained growth periods. American post-World War history says, from the sunshine comes a hail storm, just as sure as day follows night. We have kind of beaten that a little bit here lately.

Thank you very much.

Chairman **Sasser**. Thank you, Senator Domenici.

Thank you, Dr. Greenspan, for giving us two and a half hours of your time here today. We appreciate your testimony, and these hearings are closed.

[Whereupon, at 12:32 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR SANFORD TO DR. GREENSPAN AND THE RESPONSES

Questions: Do you agree that the debt as well as the deficit is a problem we should not ignore?

If we increase the gross federal debt in 1993 by $200 billion or more, I contend that we will still have a significant deficit problem with our federal budgets. If that is the case, and it is according to OMB and CBO projections, does it not make sense to develop a mechanism that takes our real deficits -- without the use of Social Security reserves, and lay out real budget reduction targets that first eliminate the annual deficits, but then continues to reduce the gross federal debt? It seems to me that sooner or later we must do this. Why not start this year or next? Why wait for GRH to play itself out in 1993 when it can only reach a false goal?

Why do you believe Wall Street views the Gramm-Rudman deficit reduction targets as credible when they don't reflect the real annual increases in our gross federal debt?

If Congress eventually gets to a point of actually reducing the gross federal debt, what would you consider a reasonable level of debt that should be achieved over the long run?

Answer: I agree that looking at the size of the national debt provides another useful perspective on the federal fiscal problem. It is worth noting, in this regard, that the ratio of the national debt to GNP has risen substantially in recent years, a worrisome trend, indeed. If we succeed in reaching the budgetary position that I have recommended, namely one of annual surplus, then we shall be retiring debt and thereby freeing up funds for use in financing private capital formation.

I don't believe that, as a matter of economic analysis, it is necessary to set aside the social security trust fund, in formulating the budget objectives; I think it is more a question of whether such accounting would lend itself to a more disciplined political process in addressing the budget issue.

I suspect that "Wall Street" is looking at the government on a consolidated basis, for that is how one makes the most meaningful assessment of the impact of the federal sector on the capital markets.

I don't think it is possible to specify a particular target path for the national debt; as I've suggested, the key at this point is to get the federal sector into surplus so that the debt will be moving in the right direction.

For use at 10:00 a.m., E.S.T.
Tuesday
February 21, 1989

Board of Governors of the Federal Reserve System

Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

February 21, 1989

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 21, 1989

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Alan Greenspan, Chairman

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Section 1: Monetary Policy and the Economic Outlook for 1989

Overall, 1988 was another year of progress for the U.S. economy, marked by further substantial increases in output and employment and by a significant improvement in the balance of trade. The dramatic stock market break of October 1987 did seem to affect real activity for a time, but the underlying strength of the economy soon showed through, and, apart from losses of farm output caused by the drought, growth proceeded at a relatively strong pace throughout 1988. Moreover, the sizable employment gains in January of this year suggest that the economy entered 1989 with considerable forward momentum.

Inflation has remained in check into the seventh year of the expansion. Even so, developments during 1988 were a little worrying, as, for a second year, increases in prices were somewhat larger than in earlier years of the expansion. Part of the pressure on prices in 1988 came in the food area and reflected the influence of the drought. However, with labor markets tightening, there also was a quickening in the rise of wages and total hourly compensation, which affected prices more generally.

Federal Reserve policy mirrored the changing economic circumstances of 1988. Early in the year, as in late 1987, the Federal Reserve sought to limit repercussions from the plunge in stock prices and, in particular, to guard against the possibility of a significant contraction in business activity. Pressures on the reserve positions of depository institutions were eased a bit further in early 1988, and interest rates edged down for a time, extending the declines that had begun in October of 1987. Growth of M2 and M3 was fairly rapid during this period, nearly reaching the upper bounds of the annual target ranges established by the Federal Open Market Committee (FOMC).

As it became clear in the spring that the economy still was strong, the focus of Federal Reserve policy shifted. For much of the year, there was heightened concern about the potential for increased inflation, largely reflecting rapid growth of spending and a continued tightening of labor and product markets. A sharp upswing in real net exports of goods and services that had begun in 1987 continued into 1988, and while this upturn was a welcome and necessary part of the adjustment of the U.S. economy toward a better balance in its external accounts, it also intensified the demands on U.S. producers at a time when the utilization of domestic labor and capital already was quite high. Accommodating the improvement in our external position while limiting the risk of heightened inflation required restraint on the growth of domestic demand.

The shift by the Federal Reserve toward restraint was reflected in a tightening of the reserve market conditions that began in late March and continued, in several steps, into 1989. Short-term market interest rates moved up during this period, influenced both by the System's tightening and the strength of the economy, and the discount rate was raised in August, to its current level of 6½ percent. Growth of M2 moderated after the spring and ended the year just below the middle of the 1988 target range. The growth of M3 also ebbed over the last two quarters, as the needs of banks and thrifts to fund credit expansion slackened.

At present, short-term interest rates are about 2½ percentage points higher than they were early last spring. Long-term interest rates, by contrast, have changed little, on net, over that same period; although these rates turned up in the spring of 1988, they leveled off over the summer and edged down in the fall, even as short-term rates were continuing to rise. This behavior of bond yields seems to have reflected a lowering of market expectations of long-run inflation.

Monetary Policy for 1989

The commitment by the Federal Reserve to contain inflationary pressures is reflected in the FOMC's decisions to lower the ranges for monetary and credit expansion this year. The Committee has set a range of 3 to 7 percent for M2 growth during 1989 and a range of 3½ to 7½ percent for M3, reaffirming the target ranges established tentatively in June 1988. These ranges were reduced from those for 1988 – a full percentage point for M2 and one-half percentage point for M3 – signalling the Committee's determination to resist any upward tendencies in inflation in the coming year and to promote progress toward price stability over the long run. The monitoring range for growth of domestic nonfinancial debt for 1989 was set at 6½ to 10½ percent, which also is lower than that of last year.

In recognition of the degree to which the relationship between monetary aggregates and economic performance has varied in this decade, the Committee retained the four percentage point spread between the upper and lower ends of the growth ranges that it adopted in 1988. Despite the deregulation of deposit interest rates, M2 velocity has remained very sensitive to changes in market interest rates over periods as long as a year or more. Depository institutions have been

Ranges of Growth for Monetary and Credit Aggregates

Percent change, fourth quarter to fourth quarter	1987	1988	1989
M2	5½ to 8½	4 to 8	3 to 7
M3	5½ to 8½	4 to 8	3½ to 7½
Debt	8 to 11	7 to 11	6½ to 10½

slow to adjust some of their offering rates, causing substantial changes over the short- and intermediate-term in the relative attractiveness to savers of deposits versus market instruments. In these circumstances, it is difficult to specify in advance a narrow range for the appropriate growth of M2 and the other aggregates in the coming year; such growth will depend on the forces affecting the economy and prices and on the response of depository institutions to any changes in market interest rates, both of which are subject to a substantial degree of uncertainty. Moreover, in 1989, the behavior of M2 and M3 also could be influenced by the resolution of problems in the thrift industry, depending, in part, on how pricing practices of these institutions change, on the reactions of retail and wholesale depositors in these institutions, and on the extent of any restraints on the growth of assets of savings and loan associations.

M2 and M3 are now around the lower ends of their 1989 ranges. This slow growth and the accompanying rise in velocity reflect the continuing effects of recent increases in market interest rates. In light of the slow adjustment of deposit rates, velocity could continue to increase, with growth in these monetary aggregates in the lower halves of their ranges. Given the uncertainties about the relation of movements in the aggregates to prices and output, the Committee agreed that in implementing policy, they would need to assess, in addition to the behavior of money, indicators of inflationary pressures and economic growth, as well as developments in financial and foreign exchange markets.

The Committee will continue to monitor the growth of domestic debt in 1989. The expansion of debt of nonfinancial sectors may slow a little from the 8¾ percent pace of 1988, although it is expected once again to exceed the pace of growth in nominal income. The growth of debt could be importantly affected by corporate financial behavior. The expansion of private debt has been boosted in recent years by the substitution of debt for equity in connection with leveraged buyouts and other corporate restructurings, and business borrowing is likely to be especially sizable in the early part of this year, owing to the recent heavy volume of such activity. The federal government, once again, will be placing heavy demands on credit markets, financing its continuing deficit.

Economic Projections

In general, the Committee members, including the nonvoting Reserve Bank presidents, anticipate that real GNP will grow moderately in 1989, that prices will rise at a pace similar to, or perhaps slightly above, that of 1988, and that the unemployment rate will remain near its recent level – the lowest in a decade and a half. On balance, the FOMC members anticipate a little less real growth and a somewhat higher rate of inflation than does the Administration, but the differences are not large.

Members of the Committee believe that the progress of the economy in 1989 will be determined in large measure by developments on the inflation front. Although special factors, such as the drought, contributed to price increases last year, there also have been troubling indications – most notably in recent wage trends – that inflationary pressures have become more widespread and, potentially, more deeply rooted.

Given the tightening actions taken by the Federal Reserve over the past year and the policy of continued restraint on aggregate demand expressed in the monetary targets for 1989, the members of the Committee anticipate that, if there is any further acceleration of prices from the 1988 pace, it will be quite limited. The majority of the Committee members expect that the consumer price index will rise about 4½ to 5 percent this year. This would be a slightly larger increase than in 1988, and thus would represent something of a setback relative to the Committee's disinflationary objective. However, in light of the tautness of markets and the current momentum of wages and prices, these members viewed such a projection as realistic in the

Economic Projections for 1989

	1988 Actual	FOMC Members and Other FRB Presidents	
		Range	Central Tendency
Percent change, fourth quarter to fourth quarter			
Nominal GNP	7.0	5½ to 8½	6½ to 7½
Real GNP	2.7	1½ to 3¼	2½ to 3
Consumer price index	4.3	3½ to 5½	4½ to 5
Average level in the fourth quarter, percent			
Unemployment rate	5.3	5 to 6	5¼ to 5½

context of a prudent effort to restore price stability over time. It should be noted, however, that some members expect a rise in prices that is significantly below the central-tendency range; in their view this far more desirable outcome could flow from the dollar's recent firmness, which will damp the pressures from rising import prices, and from the recognition by business and labor that restraint is needed to preserve gains in international competitiveness.

A particular uncertainty in the inflation outlook for 1989 centers on the prospects for food prices. FOMC members generally assumed that a return to more normal weather conditions this year, together with an increase in acres planted, would lead to a sharp rebound in crop production, in which case food prices might help to temper overall inflation. However, because stocks of some key agricultural commodities have been reduced to low levels, there also is risk that another year of drought could generate strong upward pressures on prices. In the energy area, consumer prices could rise sharply early this year, responding to the runup in oil prices around the end of 1988; nonetheless, world oil supplies still look ample, and members of the Committee are assuming that energy prices will increase only moderately over 1989 as a whole.

With respect to real GNP, the central tendency forecast of the Committee members is for a rise of about 2½ to 3 percent in 1989, about the same as in 1988. However, this forecast incorporates a working assumption that increased farm output will add around two-thirds of a percentage point to the growth of GNP–similar to the amount that the drought pared from 1988's growth. Excluding this swing in farm output, the central-tendency forecast is for considerably slower growth of real output than last year's gain, excluding drought losses, of more than 3 percent.

Although the economy clearly has entered 1989 on a strong note–even discounting the transitory influence of unusually mild weather in many parts of the country–the members feel that growth soon will move to a lower trajectory, owing both to the general influence of monetary restraint and to a number of sector-specific trends. In the business sector, the boom in capital outlays that was evident in the first half of 1988 has since abated, and surveys of plans for 1989 point to moderate gains in overall plant and equipment spending. Government purchases are expected to be held down by budgetary constraints; defense purchases, in particular, have been trending lower under the influence of cutbacks in real spending authority. Recent increases in mortgage rates likely portend some slackening in the pace of homebuilding, and the growth of consumption expenditures also should begin to taper off from the rapid pace of 1988, as a slowing of expansion elsewhere in the economy damps the growth of real disposable income.

With regard to the external sector, real net exports of goods and services declined over the second half of 1988, but most members of the Committee expect some improvement in the months ahead. However, substantial further progress in external adjustment will require a continuing commitment on the part of U.S. firms to capitalize on the enhanced competitiveness resulting from the depreciation of the dollar since 1985. That commitment must take the form not only of continued cost control and price restraint, but also of more intense efforts at marketing abroad and investment in new capacity where constraints are visible. Failure on these counts would almost certainly leave the U.S. economy considerably less well off over the long haul.

Government policy can do much to encourage businesses to make the longer-range commitments needed to bring about better balance in the economy and to foster longer-run growth. A monetary policy directed steadfastly at movement toward price stability is one critical ingredient. But also crucial is action to bring about further progress toward balance in the federal budget. The Committee has assumed that Gramm–Rudman–Hollings targets will be adhered to in the fiscal 1990 budget process, but the creation of an environment favorable for economic growth with stable prices requires that fiscal policies be put in place to produce the prescribed budget results in the out-years as well.

Section 2: The Performance of the Economy in 1988

The U.S. economy completed a sixth year of expansion in 1988. Real GNP rose about 2¾ percent over the course of the year, the number of jobs increased more than 3½ million, and the unemployment rate remained on a downward course, closing the year at 5.3 percent, its lowest level in 14 years. Progress also was made toward restoring external balance, as the merchandise trade deficit fell sharply.

The year began on a note of uncertainty. The sharp break in the stock market in the fall of 1987 had raised concern that the economy might falter, and some signs of weakness did emerge around the start of 1988. By early spring, however, it became clear that the expansion still had considerable vigor, coming in particular from rising exports and a boom in capital spending. Households, meanwhile, adjusted fairly readily to the loss of stock market wealth, and consumer spending rose at a strong pace throughout the year. Toward the end of the year, net exports and capital spending softened, but there was enough impetus from other sectors to keep real GNP on a firm upward course.

The rate of inflation, which had picked up in 1987, remained somewhat higher in 1988 than in earlier years. The step-up in inflation in 1987 had resulted mainly from a rebound in the price of oil and the passthrough of higher prices for imports. This past year, by contrast, extra price pressures reflected the impact of drought on the price of food and, more generally, a widespread pickup in labor costs in the domestic economy.

The rise in real GNP last year would have exceeded 3 percent, but for a severe drought – one of the worst of this century – that caused huge losses of farm output. These losses accounted for most of the slowdown in GNP growth that occurred after the first quarter of 1988. Fortunately, inventories of farm products had been sizable coming into 1988, and a drawdown of stocks helped to buffer households and others from the disruption to output. Within the farm sector, the drought strained the finances of some producers, but the financial condition of many others was not seriously affected, and the sector as a whole remains stronger fundamentally than in the first half of the 1980s, when the boom of the previous decade was unwinding.

In most of the nonfarm economy, the growth of activity was robust in 1988. Production in the manufacturing sector increased 5 percent, nearly matching the previous year's gain, and factory employment rose sharply. Employment also continued to grow rapidly in retail and wholesale trade and among the providers of business and health services. However, oil drilling, which had turned up in 1987 when oil prices were rising, experienced renewed weakness in 1988, intensifying economic stresses in some parts of the country.

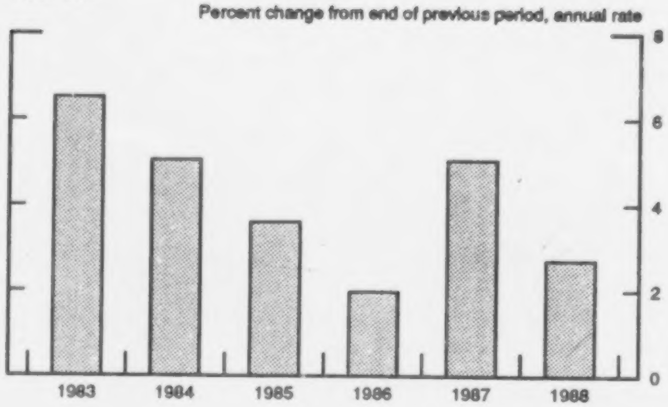
The External Sector

The U.S. external accounts showed considerable improvement during 1988. On a balance of payments basis, the deficit on merchandise trade fell from an annual rate of $165 billion in the fourth quarter of 1987 to around $120 billion in the second quarter of 1988 and, on average, remained at that lower level in the second half of the year. Over the four quarters of last year, the value of exports rose more than 20 percent; adjusted for inflation, the increase was around 15 percent. Much of the strength in exports, which was concentrated in the first half of the year, appeared to be associated with an improvement in the price competitiveness of U.S. products, resulting from an earlier depreciation of the dollar, as well as with efforts at cost control and increases in productivity among domestic producers. Demand for exports also was supported by surprisingly strong economic growth in other industrial countries. The growth in real export volume was spread over most categories of trade; gains were particularly large for capital goods (especially computers and computer parts), automotive products, and consumer goods. The volume of agricultural exports for 1988 was up 9 percent from that of 1987, despite declines in the second half of the year; the value of these exports was boosted further by the drought-induced rise in crop prices.

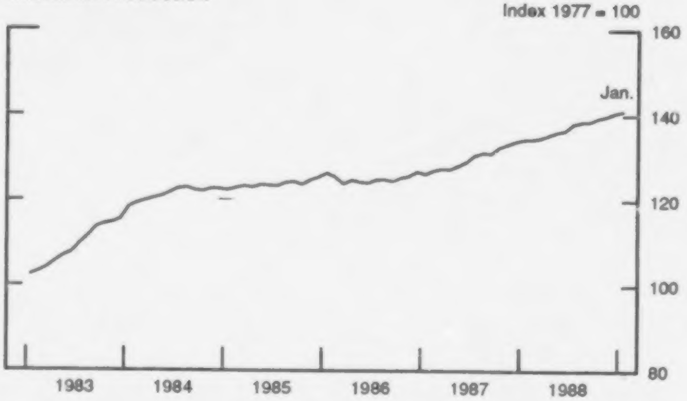
The value of merchandise imports, other than oil, rose about 7 percent during 1988. The volume of non-oil imports increased about 2 percent. This rise was concentrated mainly in the capital goods area; volume was down for other major categories of imports. The prices of imported industrial supplies (excluding oil) rose significantly in 1988; smaller increases were recorded for consumer goods, automotive products, and various machinery categories. However, price declines for oil and computers held the overall increase in import prices below that of 1987; on a fixed-weight basis, the rise in non-oil import prices during 1988 was 7¼ percent. The value of oil imports declined last year, as an increase in physical volume was more than offset by the decline in price.

For the first three quarters of 1988, the current account showed a cumulative deficit of $102 billion,

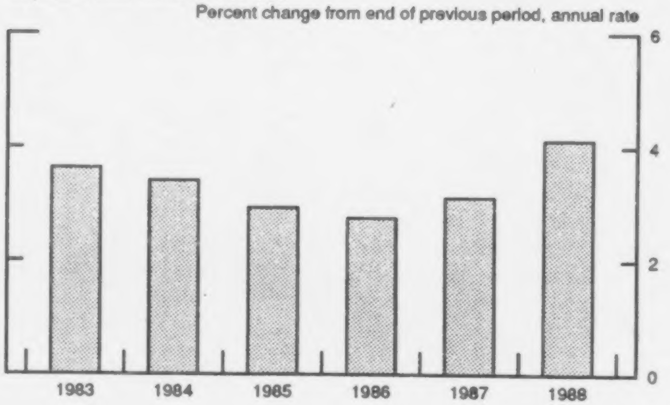
Real GNP



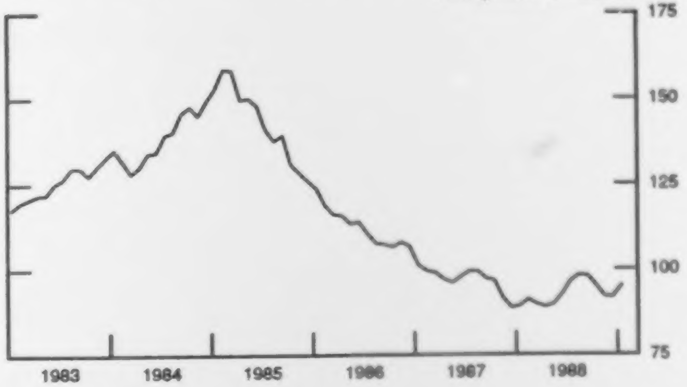
Industrial Production



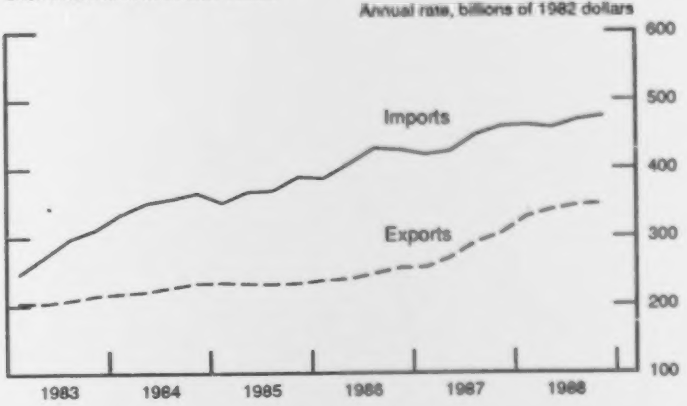
Implicit Price Deflator for GNP



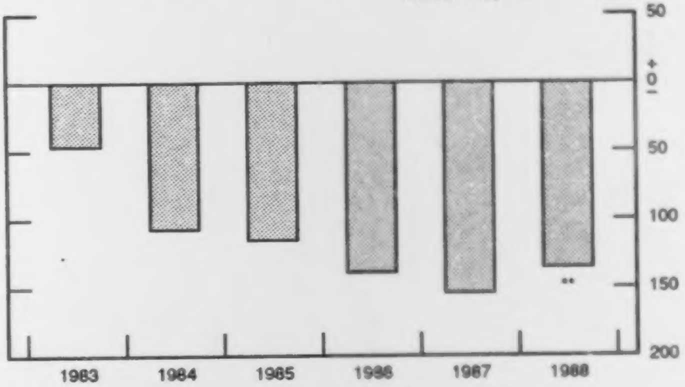
Foreign Exchange Value of the U.S. Dollar *



U.S. Real Merchandise Trade



U.S. Current Account



* Index of weighted average foreign exchange value of U.S. dollar in terms of currencies of other G-10 countries plus Switzerland. Weights are 1972-76 global trade of each of the 10 countries.

** Average of first three quarters of 1988, at an annual rate.

which was balanced by recorded net capital inflows of $88 billion and a statistical discrepancy of $14 billion. Foreign official assets in the United States increased $28 billion on net (this rise included about $30 billion, on net, of official purchases of U.S. government securities). Net inflows through banks were $21 billion. Excluding banking flows, assets held in the United States by private foreigners increased $68 billion on net; purchases of U.S. government securities were sizable (in contrast to net sales in 1987), and direct investment by foreigners in the United States remained near record levels. Excluding bank flows, the assets held abroad by private U.S. residents increased $26 billion. These recorded capital flows during the first three quarters of 1988, plus the likely net inflows in the fourth quarter, brought the recorded U.S. net indebtedness to foreigners to almost $500 billion at the end of 1988.

The foreign exchange value of the U.S. dollar, which had fallen sharply from early 1985 through the end of 1987, has shown wide fluctuations in the subsequent period. Measured against the other G-10 currencies, the dollar currently is up somewhat, on net, from its end-of-1987 low. However, it has declined in real (price-adjusted) terms against the currencies of our major trading partners among the developing countries, especially South Korea, Mexico, and Brazil.

From mid-April to late August of last year, the dollar rose sharply, on average, against the currencies of the other industrial countries, reflecting the influences of Federal Reserve monetary tightening and monthly trade reports that brightened the market's assessment of the outlook for U.S. external adjustment. When measured against a weighted average of the other G-10 currencies, the appreciation during that period was more than 15 percent. After holding steady through September, the dollar then declined sharply in October and November; market perceptions appeared to shift during that period toward a view that monetary restraint in other countries had increased relative to that in the United States, and incoming trade data suggested a stalling of the adjustment process. Since November, the dollar has again risen, partly in response to further tightening actions by the Federal Reserve.

Measured against the G-10 currencies, the dollar currently is about 7 percent above its December 1987 level. If adjustment is made for changes in relative prices, the resulting real appreciation is somewhat greater, as inflation in the United States has exceeded the weighted average of inflation rates of the other major industrial countries.

The Household Sector

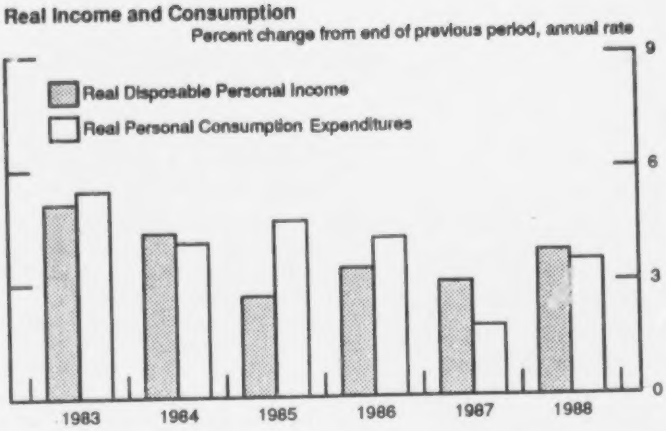
At the start of 1988, concern about the possible effect of the stock market break on the real economy centered on the household sector. The drop in share values had pared roughly half a trillion dollars from household wealth, and the degree to which spending would be cut in response to this loss of wealth was not clear.

In the event, the loss of wealth may indeed have left an imprint on consumer demand. The personal saving rate did rise after the crash and, over the next year, averaged about a percentage point higher than in the year preceding the crash. But, with exports and capital investment booming, the growth of jobs and real incomes remained strong in 1988, and the uncertainties spawned by the crash soon gave way to renewed optimism among households. Thus, after the initial, one-time jump in the saving rate, real consumption expenditures grew at about the same pace as the trend in after-tax income; the rise over the year was about 3½ percent.

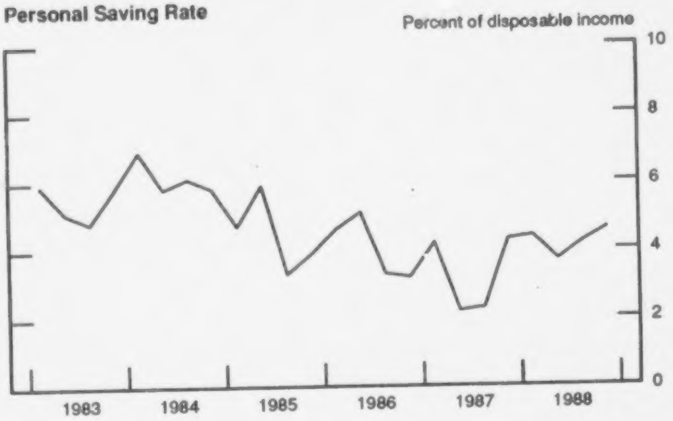
Consumer spending for big-ticket items was brisk in 1988. The unit sales of domestically produced automobiles moved up a bit from the 1987 pace, and the sales of light trucks and vans, which have more than doubled since the expansion began in 1983, reached another new high. Adjusted for inflation, total consumer spending for motor vehicles increased 6½ percent over the four quarters of the year. Among the household durables, real outlays for furniture and appliances, which had slowed in 1987, moved up 7½ percent during 1988, renewing the strength that had been evident over the 1983–86 period.

Real residential investment fell slightly in the first half of 1988, but turned up in the second half and, by the fourth quarter, was a little above the level of a year earlier. Starts of multifamily housing units, which had slumped in 1987, fell further in the first quarter of 1988, but then flattened out over the remainder of the year; vacancy rates for multifamily dwellings remain high in many areas and are likely to hold down new construction of these units for some time. In the single-family sector, starts edged down through the first three quarters of 1988, but rebounded toward year-end to the highest levels since the fall of 1987. By historical standards, these swings in single-family starts during 1988 were relatively mild; indeed, from a longer-term perspective, the past six years have been an unusually stable period in the single-family market, in sharp contrast to the boom and bust cycles of the 1970s and early 1980s. Total housing starts, of course, have fallen sharply since 1986 because of the steep decline in construction of multifamily units.

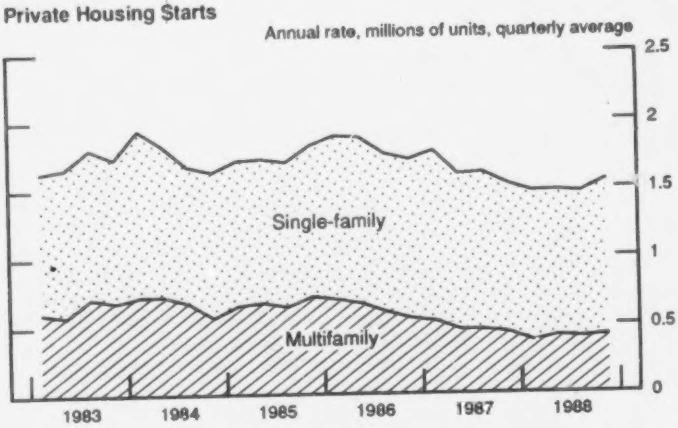
Real Income and Consumption



Personal Saving Rate



Private Housing Starts



The Business Sector

Virtually all indicators of business activity exhibited strength in 1988. Business sales, in nominal terms, rose 9 percent over the year. Hiring was brisk in most sectors, and operating rates rose further; in the industrial sector, capacity utilization at the end of 1988 was at its highest level since 1979. Corporate profits remained healthy.

A surge in business equipment spending that had begun in 1987 extended through the first half of 1988, when outlays grew, in real terms, at an annual rate of about 20 percent. The surge was led by sizable investment in high-technology items – computers, communication equipment, and the like – but outlays for other types of equipment also were strong. After midyear, the rise in equipment spending slowed, and some weakness became evident toward the end of the year. However, most reports from the field suggest that the underlying trend in equipment spending still is pointing firmly upward.

Business spending for new construction declined in 1988, reversing the moderate increase of the previous year. Commercial construction, the biggest item in the total, continued to be restrained in 1988 by the big overhang of vacancies that grew out of the building boom of the mid-1980s. Gas and oil drilling, following the lead of oil prices, fell back a little from the pace of late 1987, but remained above the lows of 1986. Construction of buildings for industrial use was little changed over 1988; although capacity utilization is high in manufacturing, many producers also appear to be limiting their needs for additional space by shifting toward technologies that use more compact equipment, by economizing on inventories, or by conserving on space in other ways.

Inventory investment, which had been sizable in late 1987, moderated in 1988, and, with sales on an upward trajectory, stock overhangs were not a problem for most businesses. In manufacturing, stocks grew more rapidly in 1988 than they have in recent years, but much of the accumulation was in industries in which orders and shipments also were generally strong; the ratio of inventories to sales for all of manufacturing moved down during the year from the already low levels of late 1987. In retail trade, concern about a possible overhang of the stocks of nondurables eased a bit during the year, as the ratio of stocks to sales in that sector edged gradually lower from a February high. By contrast, auto dealers' stocks rose sharply in the fourth quarter, and auto manufacturers have enhanced sales incentives and moved to a lower assembly rate in an effort to pare inventories. For all of manufacturing and trade combined, the ratio of inventories to sales varied little over the course of 1988 and was near the lower end of the range in which it has been since the business expansion began.

The Government Sector

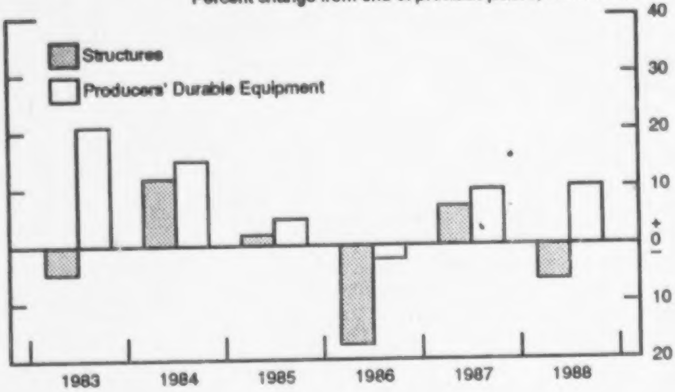
Budgetary constraints have led to a slowing of government purchases, both at the federal level and among state and local governments. The federal government's purchases of goods and services – the part of federal spending that adds directly to the gross national product – fell 4 percent in real terms from the fourth quarter of 1987 to the fourth quarter of 1988. Roughly half of the decline reflected a drought-induced reduction in the farm inventories owned or financed by the Commodity Credit Corporation (CCC), a reduction that is counted as a negative federal purchase. Excluding this inventory swing, federal purchases were down 2 percent over the year – the first decline since 1976. Over the eight years that preceded 1988, real federal purchases, other than those of the CCC, had risen at an average pace of nearly 5 percent, considerably faster than the growth of real GNP. The downturn in 1988 reflected cuts in the defense area; other non-CCC federal purchases rose somewhat over the year.

On a budget basis, total federal outlays, which are almost three times as great as federal purchases alone, continued to rise in fiscal year 1988, but at a somewhat slower rate than in most previous years. There were further increases in entitlements, greater demands on deposit insurance agencies, and increases in net interest payments. Meanwhile, the growth of federal receipts slowed in 1988 from the rapid pace of the previous year. Receipts from social security taxes rose more than 10 percent – owing in part to a rate increase in January of 1988. However, growth in receipts from personal income taxes slowed, as increases in employment and nominal incomes were offset by final reductions in income tax rates legislated under the 1986 tax reforms. The federal budget deficit in fiscal year 1988 was $155 billion, slightly above the level of the previous year.

The real purchases of goods and services by state and local governments rose 3 percent over the four quarters of 1988, a little more than in 1987, but less than the average rate of growth over the preceding three years. Spending for construction, which had risen rapidly in the mid-1980s, was little changed during 1988 as a whole, although some pickup was evident in the fourth quarter. Employment in the state and local sector continued to rise during 1988, reflecting, in part, the increased demands for teachers and other school workers associated with growth in the number of elementary students.

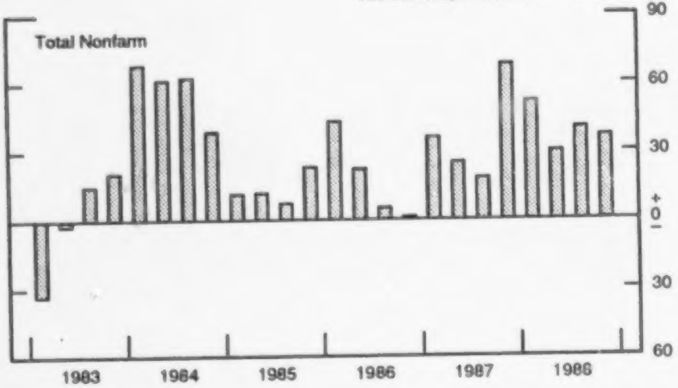
Real Business Fixed Investment

Percent change from end of previous period, annual rate



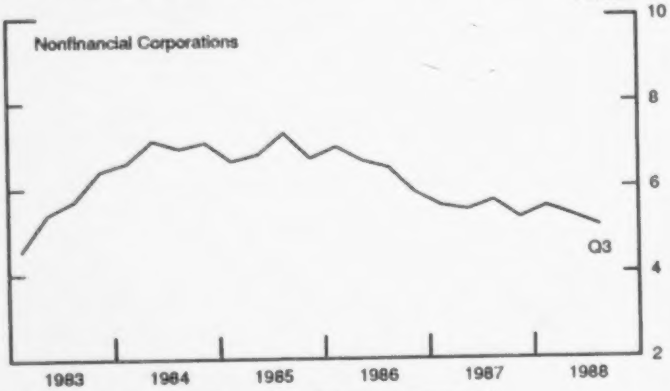
Changes in Real Business Inventories

Annual rate, billions of 1982 dollars



After-tax Profit Share of Gross Domestic Product *

Percent



* Ratio of profits from domestic operations with inventory valuation and capital consumption adjustments to gross domestic product of nonfinancial corporate sector.

The Labor Markets

The rise in the number of jobs during 1988 was somewhat above that of 1987 and brought the total increase in payroll employment since late 1982 to about 18½ million. Virtually all parts of the economy shared in last year's gain. The number of jobs in manufacturing increased 400,000; employment in construction was up 300,000. Close to a million new jobs were created in retail and wholesale trade, and 1.3 million were added in services. Except for a brief slowdown in the summer, the growth of jobs was strong throughout the year.

The continued rise in employment last year led to a tightening of labor markets and called attention to limits on the potential growth of the supply of labor and of output. Growth of the working-age population has slowed in the 1980s, and the increase during 1988 was the smallest annual rise in more than two decades. This slowing of popula- tion growth in the 1980s has led, in turn, to a more moderate rate of growth in the labor force, even as the rate of labor force participation, especially for adult women, has continued to rise. A big boost to output during the expansion has come from putting unemployed workers back on the job; now, however, with the unemployment rate at less than 5½ percent, the labor force is more fully utilized than at any time in the last decade and a half.

The tightening of labor markets in 1988 was associated with a pickup in the rise of wages and labor costs. The employment cost index for wages and salaries in the private nonfarm sector increased a bit more than 4 percent over the year – almost a percentage point more than in 1987. The pickup was most pronounced among white collar workers and in the service-producing industries, where unemployment rates currently are the lowest. The cost of benefits provided to employees rose 6¾ percent over the year, nearly twice the increase of 1987; the rise reflected both the hike in the payroll tax at the start of 1988 and a surge in the cost of health benefits. Total compensation per hour – wages and salaries plus benefits – rose nearly 5 percent over the four quarters of 1988, after two years in which the annual increases had been in the neighborhood of 3¼ percent.

Productivity gains slackened somewhat in 1988. The rise in output per hour in the nonfarm business sector over the four quarters of the year was only 0.7 percent – about half a percentage point below the average over this decade. This slippage in productivity growth in 1988, combined with the faster rate of increase in hourly compensation, resulted in a 4 percent rise in unit labor costs in the nonfarm business sector over the four quarters of 1988 – well above the average rate of increase during the previous five years.

Price Developments

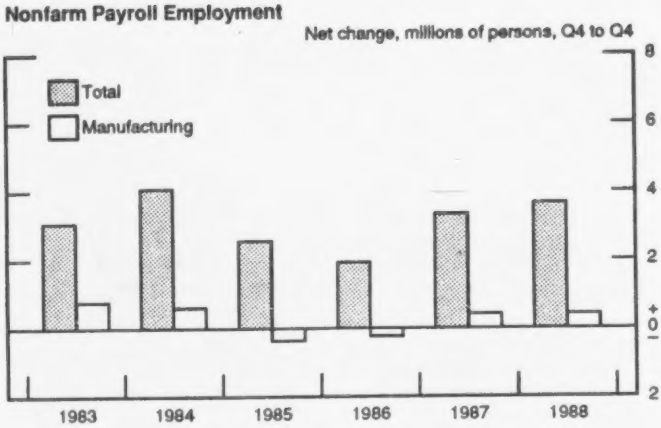
The broader measures of prices – including the GNP price measures, the producer price index, and the consumer price index – all indicate that inflation was in a range of 4 to 4½ percent in 1988. Except for the CPI, which had moved up into this range in 1987, these measures showed some acceleration last year, and all of them – including the CPI – rose more rapidly than in the first four years of the expansion. In contrast to 1987, when the indexes were boosted by a rebound in energy prices and rising prices for imports, the inflationary pressures this past year were augmented by larger increases in labor costs in the U.S. economy and the drought's influence on agricultural prices.

The drought's effects appeared quickly at the retail level in the summer, as price increases picked up for a wide variety of consumer foods. By late autumn, however, the impact of the drought on food prices began to dissipate, and inflation in the food sector returned to a more moderate path. The increase in consumer food prices over the year as a whole was 5¼ percent – about 2 percentage points above the average of the preceding five years. Prices in 1989 will be sensitive to weather developments over the spring and summer. In the past, major droughts in the United States have been one-year events, often separated in time by several good growing seasons, and most agricultural observers have been assuming that farm output will rebound in 1989, thereby restraining the prices of farm crops. Currently, however, dry conditions still prevail in some important growing regions, and crop prices could rise abruptly if moisture supplies are deficient in coming months.

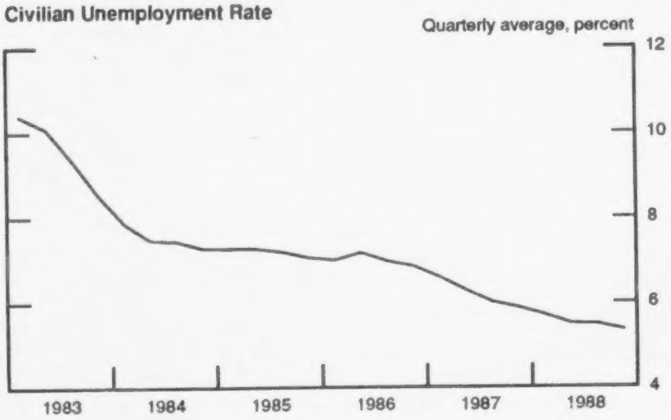
Energy prices were little changed at the consumer level during 1988 after a sharp rise in 1987 – a pattern that resulted mainly from the continued gyrations in world oil markets. The price of oil, which had risen sharply in 1987, moved lower for much of 1988, as the efforts of OPEC to restrain production unraveled. In late 1988, a new agreement by OPEC to limit production, coupled with higher-than-expected oil consumption and production shortfalls in non-OPEC countries, caused prices to rise sharply once again; however, despite these fluctuations, prices have not made any sustained departure from the range in which they generally have been since the summer of 1986.

Price increases for goods and services other than food and energy were larger in 1988 than in 1987. The pickup, while fairly moderate, was widespread and

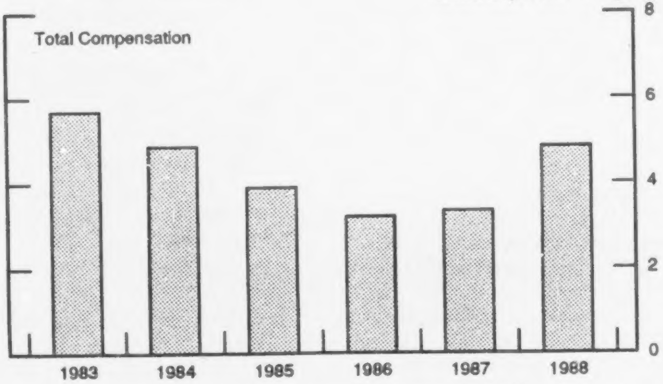
Nonfarm Payroll Employment



Civilian Unemployment Rate



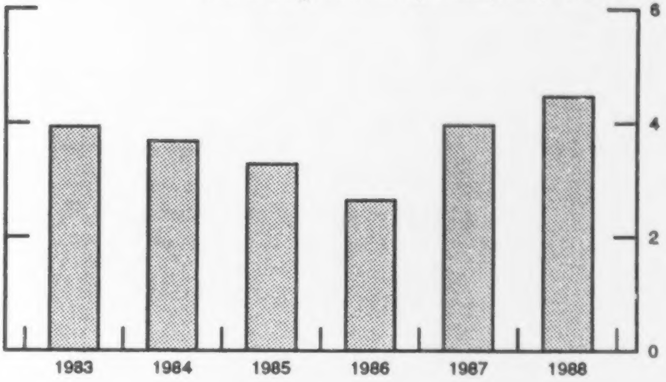
Employment Cost Index *



* Employment cost index for private industry, excluding farm and household workers.

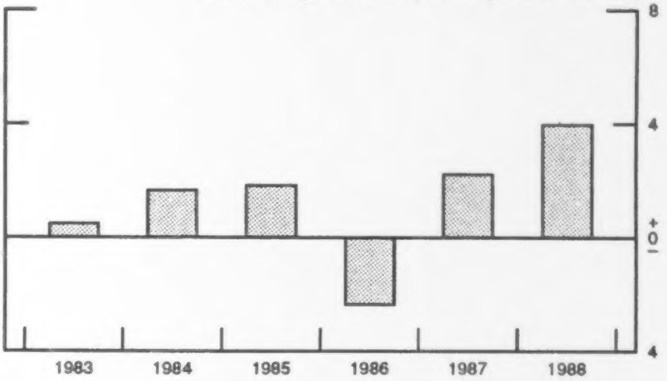
GNP Fixed-weighted Prices

Percent change from end of previous period, annual rate



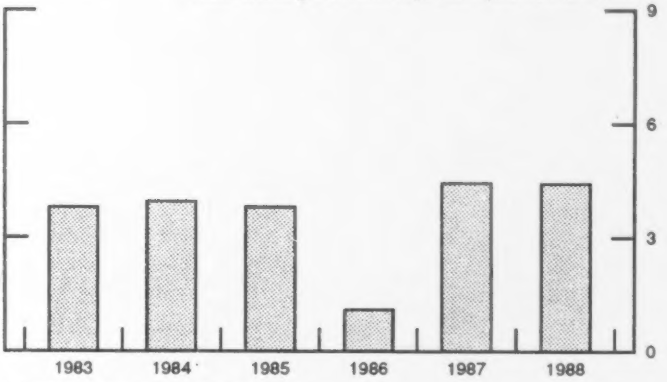
Producer Prices

Percent change from end of previous period, annual rate



Consumer Prices *

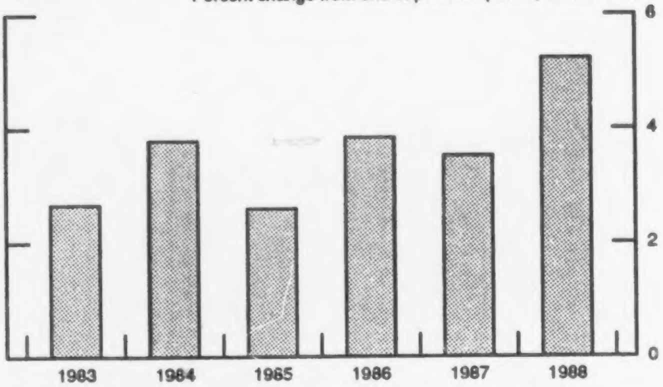
Percent change from end of previous period, annual rate



* Consumer Price Index for all urban consumers.

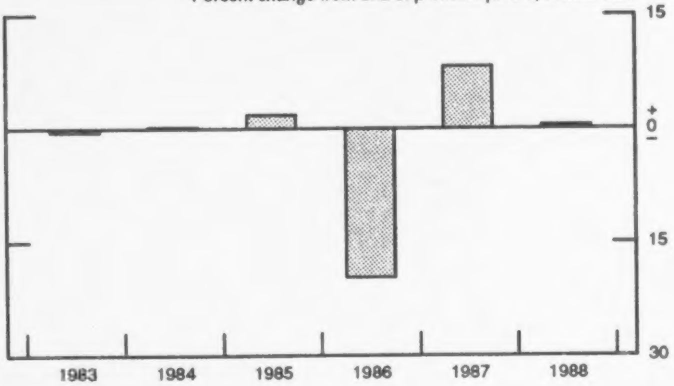
Consumer Food Prices *

Percent change from end of previous period, annual rate



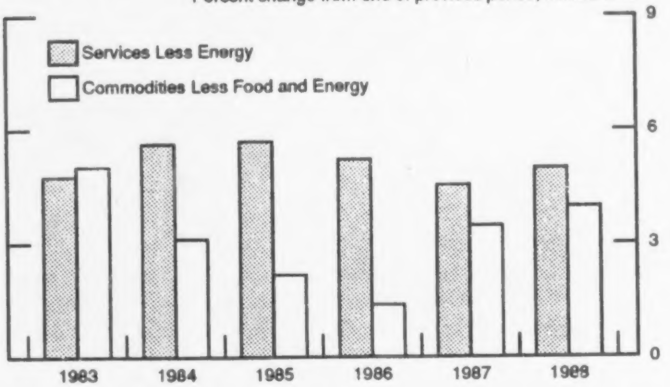
Consumer Energy Prices *

Percent change from end of previous period, annual rate



Consumer Prices Excluding Food and Energy *

Percent change from end of previous period, annual rate



* Consumer Price Index for all urban consumers.

probably reflected, in large part, the past year's acceleration in hourly compensation and unit labor costs in the domestic economy. By contrast, the pressures from rising import prices appeared to be a bit less pronounced than in 1987. Even so, higher prices for imports probably were an influence in some areas; the retail prices of apparel, for example, rose nearly 5 percent for the second year in a row. The price increases for industrial commodities slowed in 1988 after steep increases during 1987; by most measures, however, the year-to-year rate of rise in these prices has remained somewhat above that of inflation in general. The producer prices of intermediate inputs, excluding food and energy, rose more than 7 percent during 1988, reflecting the high levels of capacity utilization in a number of industries, as well as the tightening of labor markets.

Section 3: Monetary Policy and Financial Developments During 1988

During 1988, Federal Reserve policy continued to be characterized by a flexible approach to monetary targeting, with System actions responding to emerging conditions in the economy and in financial markets, as well as to growth of the monetary aggregates. This approach has been necessitated by the short-run variability in the relation of these aggregates to economic performance, owing primarily to their sizable response to changing interest rates, in addition to spending. In the early months of last year, monetary policy was eased in light of incoming data suggesting a weakening in the economic expansion and the possibility of further financial market disruptions. Subsequent information, however, suggested a growing threat of inflationary pressures, as the economic expansion remained strong and margins of available labor and productive capacity dwindled. To head off a potential acceleration of inflation, the Committee tightened reserve conditions in a series of steps beginning in the spring and extending into 1989. The monetary aggregates were running close to the upper ends of their growth ranges prior to the tightening actions, but subsequently slowed, and they closed the year in the middle portions of their ranges.

Implementation of Monetary Policy

During the early months of last year, the Federal Open Market Committee sought to counter any economic weakness that could result from the stock market break and to ensure the smooth functioning of domestic financial markets. Indicators of aggregate demand suggested that there was a risk of weakness in the economy that warranted some easing of monetary policy. In addition, special emphasis was placed on monitoring domestic financial markets for signs of any new distress and on being alert to the need to alter the provision of reserves quickly in response to any trouble. Against this backdrop, reserve conditions were eased slightly in early February, contributing to reductions in short- and long-term interest rates.

Throughout the spring, incoming economic data suggested that the economy had overcome the effects of lower equity prices on confidence and spending. This information indicated that the economy was expanding at a rate that threatened progress toward long-run price stability. Bond yields increased during this period, as indications of economic strength contradicted the earlier market forecasts of a general slowdown and raised concerns about an uptrend in inflation. Based on evidence of a greater potential for higher wage and price inflation and in the context of rapid growth in M2 and M3, the Federal Reserve firmed reserve conditions further in a series of steps beginning in March and culminating in early August with a one-half percentage point hike in the discount rate. These moves brought about substantial increases in short-term interest rates, but were accompanied by only small increases in Treasury bond yields, as investors viewed Federal Reserve actions as heading off a long-term acceleration of inflation. The upturn in short-term interest rates, coupled with more optimistic expectations of future inflation, helped boost the foreign exchange value of the dollar during this period.

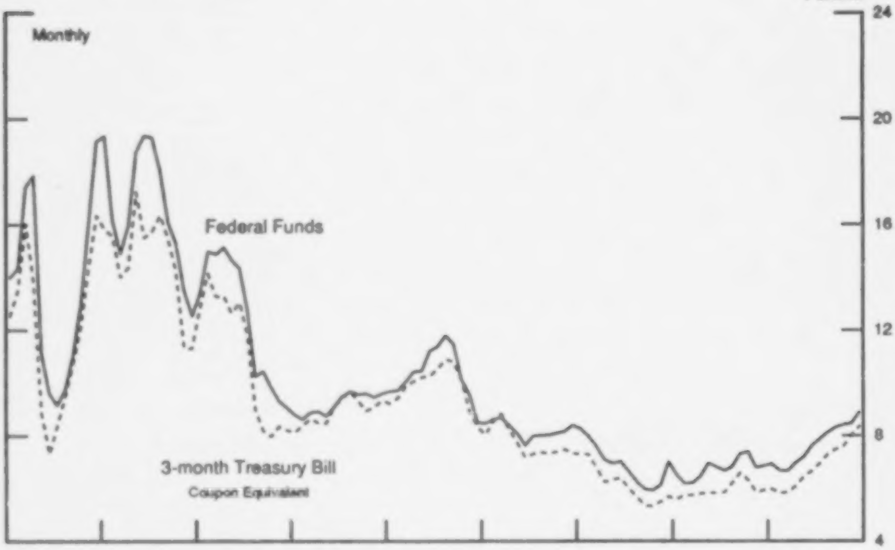
In view of the policy restraint already in place, which was being reflected in slowing growth in the monetary aggregates, and some signs that economic growth may have been moderating, the Committee postponed any further action over the late summer and early fall, awaiting further information on the course of the economy. During October and November, the foreign exchange value of the dollar declined, partly in response to a rise in foreign interest rates relative to U.S. market interest rates and to investor concern over the lack of progress in reducing the U.S. federal budget deficit and the slowing improvement in the U.S. trade deficit.

In late fall, incoming data suggested that previous monetary restraint had not been sufficient to relieve the potential for higher inflation and the Committee resumed tightening reserve conditions in a series of moves beginning in November and extending into the new year. As a result of these measures, short-term market interest rates rose. In contrast, bond yields continued to fluctuate narrowly, signalling the market's continued confidence that inflationary pressures would be contained. This confidence together with the firming of policy contributed to a strengthening of the foreign exchange value of the dollar.

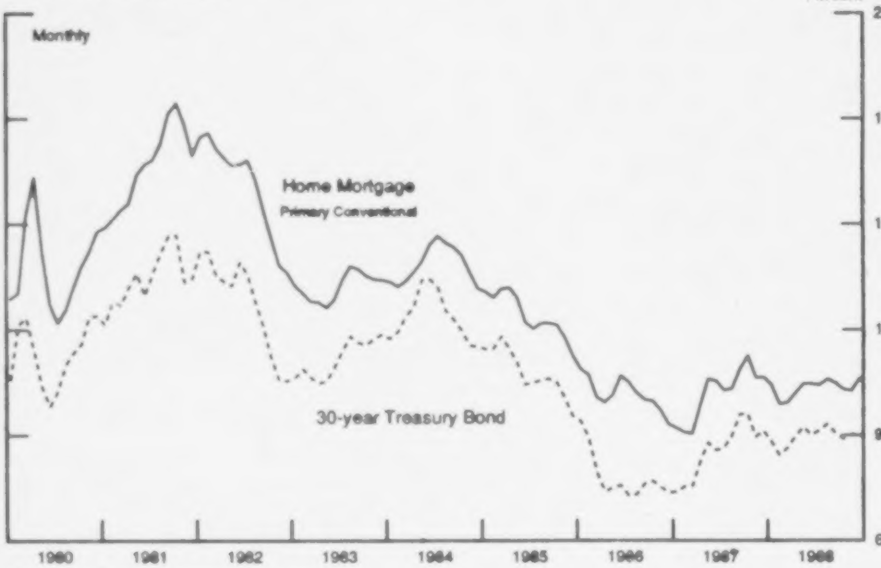
Behavior of Money and Credit

M2 expanded 5.3 percent last year, just below the middle of its 4-to-8 percent target range. Although demands for M2 were supported by strong growth in income and spending, they were reduced by increases in its opportunity cost – that is, the difference between market interest rates and the yields on M2-type instruments. Early in the year, opportunity costs had declined in response to decreases in market interest rates relative to deposit rates in late 1987 and early 1988,

Short-Term Interest Rates



Long-Term Interest Rates



Observations are monthly averages of daily data;
last observation is for December 1988.

leading to strong growth in M2 and a decline in its velocity – the ratio of nominal GNP to M2 – during the first quarter. But as market interest rates moved upward after March and deposit rates lagged behind, its velocity subsequently reversed, rising 1.7 percent for all of 1988. The response of offering rates was especially sluggish in the last part of 1988. One reason for this may have been regulatory pressure on thrifts and the closing of many insolvent institutions, which often had been overly aggressive in pricing deposits. The extent to which thrifts were offering higher rates than banks on small time deposits was greatly reduced, and partly as a consequence, growth of retail deposits was much stronger at banks than at thrifts.

The composition of the growth of the components of M2 also responded to changes in deposit rates and market interest rates. Yields on liquid deposits – interest-bearing checking deposits, savings deposits, and money market deposit accounts – changed very little over the year. During the first half of 1988, liquid retail deposits expanded at a strong pace, largely reflecting increases in their relative attractiveness stemming from declines in market interest rates and, to a lesser extent, in rates on small time deposits. Their growth slowed markedly over the last half of 1988, following the reversal in the pattern of interest rate movements. Growth in small denomination time deposits was particularly robust throughout 1988. Expansion in the early months of the year may have resulted, in part, from shifts in household investment preferences away from stocks toward the safety of these savings instruments. Later, rising yields on small time deposits relative to those on more liquid deposits led households to shift funds from liquid to small denomination time deposit accounts.

M3 grew 6.2 percent last year, placing it slightly above the midpoint of its 4-to-8 percent target range. This increase from a 5.8 percent growth in 1987 reflected a modest pickup in the issuance of managed liabilities in M3 to fund credit expansion at banks and thrift institutions. M3 followed a trajectory near the upper end of its target range in the first half of 1988, but moderated thereafter, in association with slowing credit growth at depository institutions. For the year, large time deposits and other managed liabilities included in M3 but not in M2 grew rapidly, as inflows into M2-type deposits were insufficient for banks and thrifts to finance their desired pace of asset expansion. This was particularly true in the second half of the year when M2 growth moderated. To some extent, M3 growth last year also was bolstered compared with 1987 by a greater reliance by banks on managed liabilities included in M3 than on nonmoney stock instruments, such as bank borrowings from overseas branches. In contrast, as in recent years, the heavy use of Federal Home Loan Bank advances by thrift institutions – which are not included in M3 – has had a moderating effect on M3 growth.

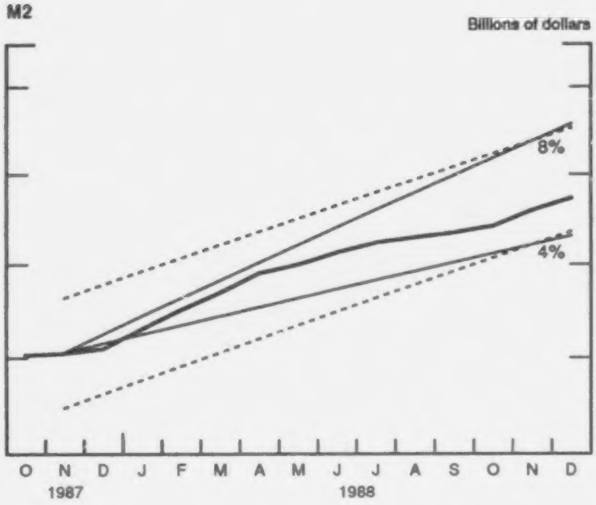
At 4.3 percent, M1 growth last year was down more than 2 percentage points from 1987. Growth of interest-bearing checking accounts moderated while demand deposits continued running off. As in recent years, the growth of M1 displayed great sensitivity to changes in market rates of interest. Households shifted savings balances between NOW accounts and those M2 components, such as small time deposits, whose yields responded to increases in market rates much more quickly than those on NOW accounts. Because substitutions of this type are internalized within M2, M2 has displayed less sensitivity to interest rates than has M1 in this decade. Demand deposits, the other highly interest sensitive component of M1, again declined in 1988 partly reflecting increases in their opportunity costs and declines in compensating balances. The amount of such balances that businesses must hold in these noninterest bearing accounts to compensate banks for services falls when interest rates rise.

The debt of domestic nonfinancial sectors expanded nearly 8¾ percent during 1988, down from 9 percent in 1987, placing it near the midpoint of the Committee's 7-to-11 percent monitoring range. Although debt expansion was well below the pace of the mid-1980s, it still exceeded nominal GNP growth. Federal debt grew marginally faster last year than in 1987. Expansion in nonfederal debt moderated, as state and local governments trimmed debt issuance, and as households expanded their mortgage debt at a less robust pace in response to higher mortgage rates. Growth of business debt picked up a bit from its 1987 pace, with short-term debt growing faster than long-term debt. Corporate borrowing was particularly strong, reflecting increased external financing needs for capital investments and for mergers, buyouts, and stock repurchases.

Other Financial Developments

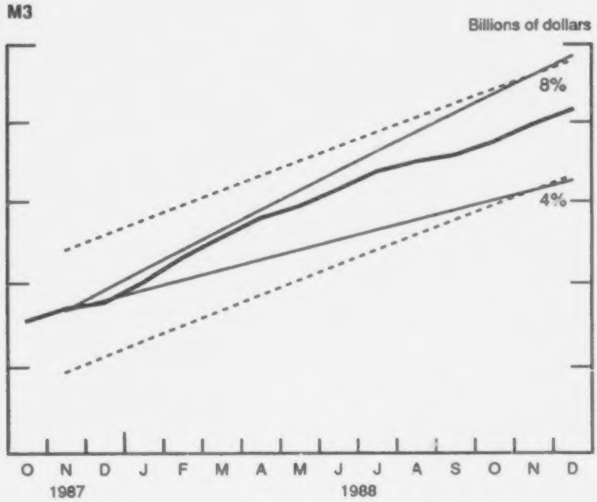
Although the economy continued to grow at a strong pace last year and the financial markets recovered from their skittishness following the stock market break of 1987, financial developments in certain markets and sectors warranted the attention of policymakers. Of particular note were the worsening condition of the thrift industry, the need to achieve sounder capitalization of commercial banking organizations, and the rising indebtedness of businesses involved in restructuring activity.

Ranges and Actual Money Growth



Rate of Growth

1987 Q4 to 1988 Q4
5.3 Percent

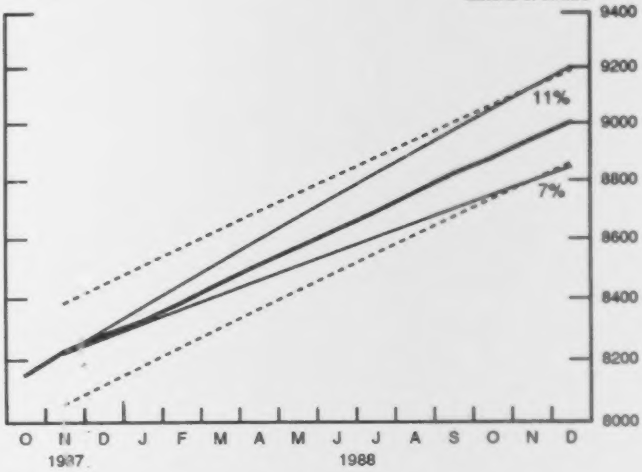


Rate of Growth

1987 Q4 to 1988 Q4
6.2 Percent

Ranges and Actual Growth of Money and Debt

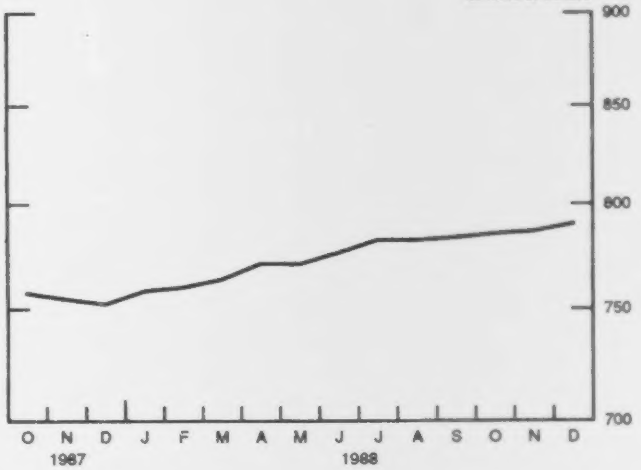
Debt



Rate of Growth

1987 Q4 to 1988 Q4
8.7 Percent

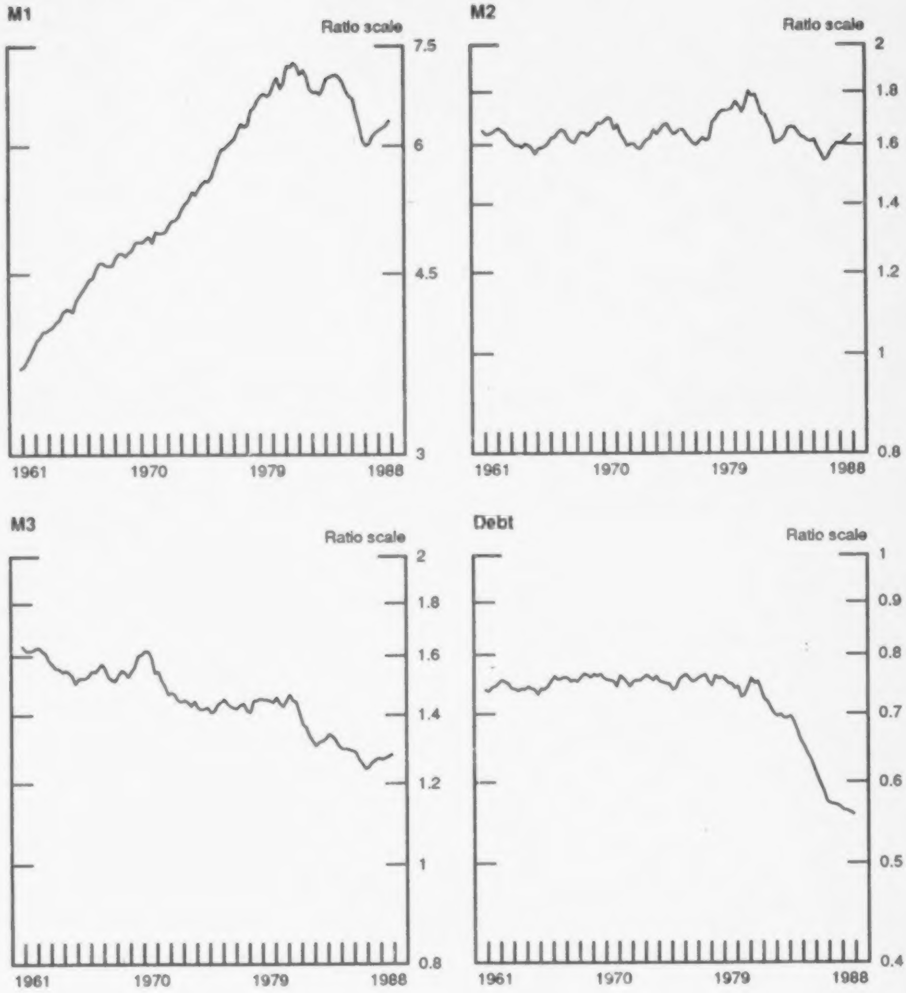
M1



Rate of Growth

1987 Q4 to 1988 Q4
4.3 Percent

Velocity of Money and Debt
(Quarterly)



Growth of Money and Debt[1] (Percentage changes)

		M1	M2	M3	Debt of domestic nonfinancial sectors
Fourth quarter to fourth quarter					
1979		7.7	8.2	10.4	12.3
1980		7.4	9.0	9.6	9.6
1981		5.2 (2.5)[2]	9.3	12.3	10.0
1982		8.7	9.1	9.9	9.0
1983		10.2	12.1	9.8	11.3
1984		5.3	7.7	10.5	14.2
1985		12.0 (13.0)[3]	8.9	7.7	13.2
1986		15.6	9.3	9.1	13.3
1987		6.4	4.2	5.7	9.8
1988		4.3	5.3	6.2	8.7
Quarterly growth rates (annual rates)					
1988	Q1	3.2	6.2	6.8	8.2
	Q2	6.4	6.9	7.2	8.7
	Q3	5.2	3.8	5.5	8.6
	Q4	2.4	3.8	4.9	8.4

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1989.
2. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.
3. M1 figure in parentheses is the annualized growth rate from the second to the fourth quarter of 1985.

As the year wore on, the dimensions of the problems facing the thrift industry became clearer. Although industry losses eased in the third quarter from their record levels in the first half of 1988, this development appears largely to have reflected FSLIC assistance transactions during the third quarter, rather than a significant underlying improvement in earnings.

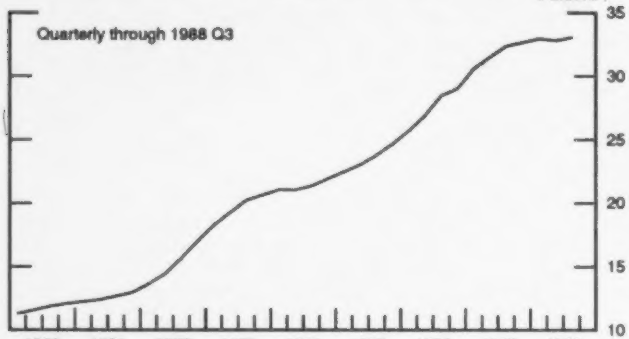
Despite the turmoil in the thrift industry, there has been no noticeable disruption of mortgage activity. In part, the development of a deep secondary mortgage market has separated the origination of loans from the need to fund them. For this reason, the base of mortgage credit has been broadened in recent years, making the provision of mortgages far less dependent on the condition of any one type of financial institution or on the regional supply of loanable funds. During the 1980s, the share of home mortgage credit held in securitized form has increased from about 10 percent to more than one-third. The spread between interest rates on fixed-rate mortgages, which have an average life of roughly ten years, and yields on ten-year Treasury notes did not change appreciably over 1988, which also implies that the mortgage markets continued functioning well despite the problems of many savings and loan associations.

In contrast to the thrift industry, preliminary data indicate that U.S. commercial bank profits were reasonably strong in 1988, even after abstracting from the one-time jump in fourth quarter earnings associated with the resumption of Brazilian debt payments. Moreover, most large money-center banks with a significant amount of loans to developing countries have continued to build capital, which provides a cushion against default losses. Giving added impetus to efforts to raise equity was the agreement by bank supervisory authorities of major industrial countries to set more stringent, risk-based standards of capital adequacy. These standards, to be fully phased in by 1992, place a greater emphasis on equity capital, take into account the off-balance sheet activities of banks, and provide a more uniform regulatory treatment of banks based in different countries.

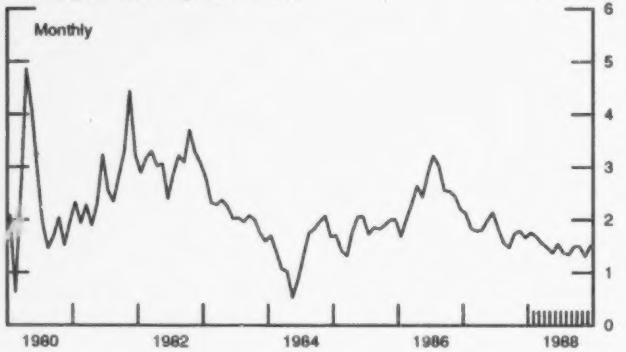
As in 1987, banks lent considerable sums to finance mergers and leveraged buyouts. Although banks have reported that these loans have had a lower rate of loss than all other business loans combined, and although LBO borrowers typically obtain some insurance against higher loan rates, concern remains about bank exposure to losses in the event of an adverse turn in business conditions. For this reason, the Federal Reserve is closely monitoring developments in this area and has just revised its bank examination guidelines to ensure that member bank loans used to finance buyouts and other highly levered corporate restructurings meet prudent credit standards.

Leveraged buyouts and other mergers and restructurings led to a record pace of net equity retirements by nonfinancial corporations in 1988. Despite the large volume of this activity in recent years, the overall corporate debt-to-equity ratio is not out of line with observations since the early 1970s, reflecting increased market valuation of equities since the early 1980s. Much of the recent financial restructuring has been a response to fundamental economic factors; it may impose a discipline on corporate management, which in turn can stimulate efforts to improve productivity. Nevertheless, heavy commitments of cash flow to service debt reduce a firm's ability to cope with stresses or industry-specific shocks. To some extent, the substitution of debt for equity is motivated by simple tax-saving considerations, such as the full deduction for interest payments and the double taxation of dividends. For these reasons, reforming the corporate tax system should be a component of public policy in addressing this difficult issue.

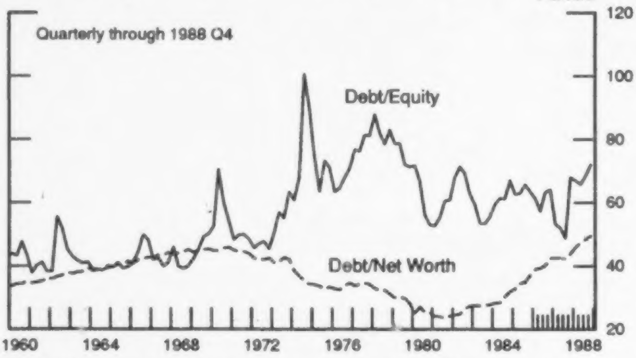
The Share of Residential Mortgage Debt Held as Securities



The Spread Between Primary Home Mortgage and 10-year Treasury Bond Rates



Debt to Equity Ratios of Nonfinancial Corporations*



*Debt and equity are at market value. In computing net worth, tangible assets are valued at replacement cost or market value while financial assets are valued at cost.

VIEWS OF THE SECRETARY OF THE TREASURY

WEDNESDAY, MARCH 1, 1989

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Jim Sasser (chairman of the committee) presiding.

Present: Senators Sasser, Exon, Lautenberg, Conrad, Robb, Armstrong, Symms, Grassley, Kasten, and Nickles.

Staff present: John L. Hilley, staff director; and Jim Carr, assistant director for tax policy and credit.

For the minority: G. William Hoagland, staff director; and Carol Hartwell, assistant staff director and senior analyst for housing and credit.

OPENING STATEMENT OF CHAIRMAN SASSER

Chairman SASSER. The committee will come to order.

This morning we are absent our distinguished ranking member, Senator Domenici of New Mexico. He telephoned this morning and indicated that he is somewhat under the weather, Mr. Secretary, but that he would do his best to try to get in before you concluded your testimony. I think he may have a little touch of the flu bug this morning, but his side is ably represented by our colleague, Senator Armstrong of Colorado.

I am pleased to welcome before the Budget Committee this morning our former colleague and friend, the Secretary of the Treasury, Nicholas Brady. As the President's chief economic spokesman, Mr. Secretary, we are pleased to have you here this morning, and the Budget Committee welcomes your views on various aspects of the President's 1990 budget.

First, we want to focus on several areas of concern, Mr. Secretary, with the 1990 budget. First is the administration's response to the crisis, in the thrift industry. I want to commend the Bush administration for their quick response to the problem in the savings and loan industry and say that I applaud their quick action to stop the hemorrhage that is taking place in this industry.

However, having said that, there are some concerns about the plan that is being advanced. My own concerns, Mr. Secretary—and perhaps you can lay those at rest this morning—are that perhaps we underestimate the full scope of the problem.

Second, I have some concerns about the interest rate assumptions being too low, and about what will happen in the savings and loan industry if interest rates go up. And indeed, I am concerned that using OMB interest rate assumptions has also caused an underestimation of the extent of the problem.

And lastly, there is some concern about the premium that is being paid for the bonds that are being utilized, because they are being financed off-budget.

At the same time, in reflecting on what has occurred, the General Accounting Office estimated that at the end of 1986, the Federal Savings and Loan Insurance Corporation had a negative net worth of $6 billion. We see now in 1989 that a conservative estimate is that it will take over $100 billion to resolve the thrift crisis, so we see how rapidly this whole problem has gone downhill.

With regard to my first concern, as I stated earlier, Mr. Secretary, the Treasury estimates that it will take some $90 billion on a present value basis to solve the thrift problem. That amount is broken into two parts, $40 billion to resolve past resolutions and $50 billion for future resolutions.

Now, as I said earlier, the Treasury plan uses OMB economic and interest rate assumptions, which may underestimate considerably the cost of the Treasury plan.

Second, the Treasury appears to have substantially underrated the taxpayer costs of the bailout. According to a preliminary Senate Budget Committee staff analysis, which I am attaching to my statement this morning for the perusal of all of our members, which uses the administration's own numbers, there may be a taxpayer contribution of some $76.7 billion to the bailout plan, rather than the $40 billion previously announced in the Treasury plan.

Finally, it has been recommended that the thrift bailout plan be financed on an off-budget basis, and this, of course, will add between $3 and $6 billion for the overall cost of the plan, because of the premium entailed and off-budget financing.

Another area of concern involves the capital gains tax, Mr. Secretary, and we will get into that later this morning. I just might say preliminarily that the President's 1990 budget says that his capital gains reduction proposal will add more than $15 billion in revenues to the Federal budget from 1990 through 1993. However, this past Friday, I and other Members of the Senate received an estimate from the Joint Committee on Taxation that the capital gains proposal would actually increase the deficit by $24 billion between 1990 and 1993. That is a $40 billion miscalculation, if it is accurate, and that is cause for great concern among budgeteers.

For the benefit of members of the committee who may not have had a chance to see this proposal, I have also attached the joint committee letter to my prepared statement.

Now, I further understand that, based on studies done by the Treasury in 1985, the capital gains reduction would provide a minimal impact on economic growth. So, we fear we have a tax proposal that may lose revenue and that does not really stimulate economic growth. Indeed, by adding to the deficit, this tax proposal further lowers the net domestic savings rate.

So, on these matters, Mr. Secretary, we will need your views on how these Treasury proposals really affect the deficit.

[The prepared statement and attachments of Chairman Sasser follow:]

BUDGET

Senate Committee on the Budget
Senator JIM SASSER, Tennessee, Chairman

Room 621 Dirksen, Washington, D.C. 20510
202/224-8695

Contact: Larry Stein

FOR IMMEDIATE RELEASE
1 March 1989 10:00p.m.

OPENING STATEMENT
OF
SENATOR JIM SASSER

I AM PLEASED TO WELCOME BEFORE THE COMMITTEE THIS MORNING SECRETARY OF TREASURY NICHOLAS BRADY. AS THE PRESIDENT'S CHIEF ECONOMIC SPOKESMAN, THE BUDGET COMMITTEE WELCOMES YOUR VIEWS ON VARIOUS ASPECTS OF THE PRESIDENT'S 1990 BUDGET.

TODAY, I WOULD LIKE TO FOCUS ON SEVERAL AREAS OF CONCERN IN THE 1990 BUDGET.

THE FIRST IS THE ADMINISTRATION'S RESPONSE TO THE THRIFT CRISIS.

I WANT TO COMMEND THE ADMINISTRATION FOR THEIR QUICK RESPONSE TO THIS PROBLEM. BUT AT THE SAME TIME IT IS IMPERATIVE THAT WE HAVE THE BEST FACTS ON THE TABLE TO ESTIMATE THE COST OF THIS BAILOUT ON THE FEDERAL BUDGET.

AT THE END OF 1986, THE GENERAL ACCOUNTING OFFICE ESTIMATED THAT THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION HAD A NEGATIVE NET WORTH OF $6 BILLION. NOW A CONSERVATIVE ESTIMATE IS THAT IT MAY TAKE OVER $100 BILLION TO RESOLVE THE THRIFT CRISIS.

IN THAT REGARD, I HAVE THREE FISCAL CONCERNS ABOUT THE TREASURY PLAN THAT I HOPE YOU WILL SHED SOME LIGHT ON TODAY.

THE TREASURY ESTIMATES THAT IT WILL TAKE SOME $90 BILLION, ON A PRESENT VALUE, BASIS TO SOLVE THE THRIFT PROBLEM. AND THAT AMOUNT IS BROKEN IN TWO PARTS -- $40 BILLION TO RESOLVE PAST RESOLUTIONS AND $50 BILLION FOR FUTURE RESOLUTIONS.

I AM CONCERNED THAT THIS ESTIMATE OF THE THRIFT BAILOUT MAY BE TOO LOW. INDEED THE TREASURY PLAN USES O.M.B. ECONOMIC AND INTEREST RATE ASSUMPTIONS WHICH MAY UNDERSTATE CONSIDERABLY THE COST OF THE TREASURY PLAN.

SECONDLY, THE TREASURY APPEARS TO HAVE SUBSTANTIALLY

UNDERRATED THE TAXPAYER COST OF THE BAILOUT. ACCORDING TO A PRELIMINARY SENATE BUDGET COMMITTEE STAFF ANALYSIS ATTACHED TO MY STATEMENT WHICH USES THE ADMINISTRATION'S OWN NUMBERS, THERE MAY BE A TAXPAYER CONTRIBUTION OF SOME $76.8 BILLION TO THE BAILOUT PLAN RATHER THAN THE $40 BILLION PREVIOUSLY ANNOUNCED IN THE TREASURY PLAN.

FINALLY, IT HAS BEEN RECOMMENDED THAT THE THRIFT BAILOUT PLAN BE FINANCED ON AN OFF-BUDGET BASIS. THIS, OF COURSE, WILL ADD BETWEEN $3 AND $6 BILLION TO THE OVERALL COST OF THE PLAN BECAUSE OF THE PREMIUM ENTAILED IN OFF-BUDGET FINANCING.

ANOTHER AREA OF DEEP CONCERN INVOLVES THE CAPITAL GAINS TAX PROPOSAL OF THE PRESIDENT.

THE PRESIDENT'S 1990 BUDGET SAYS THAT HIS CAPITAL GAINS REDUCTION PROPOSAL WILL ADD MORE THAN $15 BILLION IN REVENUES TO THE FEDERAL BUDGET FROM 1990 THROUGH 1993. HOWEVER, THIS PAST FRIDAY I AND OTHER MEMBERS OF THE SENATE RECEIVED AN ESTIMATE FROM THE JOINT COMMITTEE ON TAXATION THAT THIS BUDGET PROPOSAL WILL ACTUALLY INCREASE THE DEFICIT BETWEEN 1990 AND 1993. THAT'S A $40 BILLION MISCALCULATION AND IS REALLY GOING IN THE WRONG DIRECTION AS FAR AS I AM CONCERNED.

FOR THE BENEFIT OF MEMBERS OF THE COMMITTEE, I HAVE ATTACHED THE JOINT COMMITTEE LETTER TO MY PREPARED STATEMENT.

I FURTHER UNDERSTAND THAT BASED ON STUDIES DONE BY THE TREASURY IN 1985 -- THE REAGAN TREASURY DEPARTMENT -- A CAPITAL GAINS REDUCTION WOULD PROVIDE A VERY MINIMAL IMPACT ON ECONOMIC GROWTH.

SO HERE WE HAVE A TAX PROPOSAL THAT LOSES REVENUE AND DOESN'T REALLY STIMULATE ECONOMIC GROWTH. INDEED BY ADDING TO THE DEFICIT, THIS TAX PROPOSAL FURTHER LOWERS THE NET DOMESTIC SAVINGS RATE.

SO ON BOTH THESE MATTERS, MR. SECRETARY, WE WILL NEED YOUR VIEWS ON HOW THESE TREASURY PROPOSALS REALLY AFFECT THE DEFICIT. FOR IT APPEARS TO ME THAT PERHAPS ONCE AGAIN, WE ARE UNDERESTIMATING THE REAL IMPACT OF THESE FEATURES OF THE PRESIDENT'S BUDGET ON OUR GROWING DEFICIT PROBLEM.

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JIM SASSER, TENNESSEE, CHAIRMAN

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United States Senate
COMMITTEE ON THE BUDGET
WASHINGTON, DC 20510-6100

TO: Democratic Members of the Senate Budget Committee

FROM: Jim Sasser

DATE: February 28, 1989

RE: President's Savings and Loan Bailout Recommendations and the Extent of Taxpayer Participation

---

Taxpayer Participation

The Administration claims that the taxpayer participation in its bailout plan is roughly $40 billion. However, a closer review of the Administration's own tables reveals a far different story about taxpayer exposure.

The Administration's claim of only $40 billion in taxpayer participation is based upon the net on-budget impact of the proposal over the next decade. But this portrayal does not reflect the fact that increased FDIC premiums, which cannot be used for FSLIC, do not truly offset FSLIC expenditures. Therefore, the net budget impact specifically associated with FSLIC-associated expenditures is therefore not $39.9 billion, but $59.8 billion.

Furthermore, in a broader sense, this portrayal does not reflect the total use of taxpayer funds in the Administration's plan. It is necessary here to distinguish between the budget impact and the broader cash flows associated with the Administration's plan. Budget impact is based on measuring the authority to spend (budget authority) and the actual spending (outlays). This perspective, however, overlooks the broader flow of cash provided as a means of financing outlays. While a cash flow perspective does not immediately and easily translate into budget impact, it is critical to understanding the extent of taxpayer participation in the bailout.

The key to understanding the true extent of taxpayer participation and liability inherent in the Administration's number is two-fold. First, there is a massive substitution of taxpayer funds to finance outlays previously intended to be financed with FSLIC and industry resources. Building from the Administration's own 1989-1999 numbers, the following picture emerges. The net outlay impact of FSLIC-associated expenditures is $37.9 billion. This represents the shortfall of premium and other income necessary to cover expenses, which the Administration proposes to make up with an annual appropriation for projected losses.

The second piece of taxpayer participation reflected in the Administration's numbers reflects the net cost of liquidating the existing borrowing of the FSLIC represented by outstanding promissory notes. The Administration projects the total cost of repaying notes over the ten-year period to be $19.2 billion. The Administration plan proposes to appropriate liquidating cash (again, taxpayer funds) to cover this expense. However, it is necessary to net out of this total some $9.7 billion in new notes already issued in the first quarter of 1989, which is already accounted for in the net FSLIC outlay impact of $37.9 billion.

In addition, the Administration proposes to develop a FSLIC cash reserve of $8.8 billion by 1999. Since premium income is earmarked for this reserve, taxpayer funds again must cover this shortfall for expenditures through the appropriation for projected losses.

It is also necessary to net out any drawdown of FSLIC cash balances from the overall cash shortfall associated with the Administration's proposal. FSLIC ended fiscal year 1988 with a cash balance of almost $2.0 billion. The Administration proposes to draw this cash balance down to $0 5 billion, which will be maintained throughout the next decade as a minimum cash reserve for cases. Thus, this reduces the need for taxpayer funding by roughly $1.4 billion, which must be netted out of the total figure.

Finally, the Administration proposes direct appropriations to pay for residual interest payments on REFCORP borrowing which is not covered by other insurance fund income. The Administration's plan reflects a ten-year cost for taxpayers of $22 billion.

In conclusion, the Administration's own numbers suggest a direct taxpayer contribution of $76.8 billion, rather than the publicly announced level of $40 billion. Furthermore, the Treasury is responsible for funding any additional amounts above and beyond the resolution costs projected by the Administration's current plan. Considering the variety of uncertainties associated with the Administration's cost projections mentioned elsewhere in the memorandum, the taxpayer share of the bailout plan over the next ten years alone could be significantly higher than the $76.8 billion proposed by the Administration.

($ in billions)

	FY89	FY90	FY91	FY92	FY93	FY94	1989-1994	1989 1999
FSLIC & RTC ACCOUNT								
DISBURSEMENTS								
Old Cases & Other Expenses								
Admin and misc exp	0.3	0.3	0.3	0.3	0.3	0.2	1.6	2.8
Notes Issued	9.7						9.7	9.7
Interest on Notes Outstanding	1.4	1.5	1.1	0.9	0.8	0.7	6.4	9.2
Repay notes issued prior to FY87	0.0	0.0	0.2	0.0	0.2	0.0	0.5	0.5
Assistance Payments	5.2	4.4	3.8	4.2	3.4	2.9	24.0	28.8
Liquidations	1.0						1.0	1.0
Total Old Cases and Other Exp	17.7	6.2	5.5	5.4	4.7	3.8	43.2	52.2
New Cases								
Assisted Mergers	5.0	12.5	8.5	1.2	1.8	1.0	30.0	44.0
Liquidations	5.0	12.5	8.5	1.2	1.8	1.0	30.0	30.0
Total New Cases	10.0	25.0	17.0	2.4	3.6	2.0	60.0	74.0
TOTAL DISBURSEMENTS	27.7	31.2	22.5	7.8	8.3	5.8	103.2	126.2
COLLECTIONS (-)								
FICO proceeds (CEBA)(-)	-3.8	-3.3					-7.1	-7.1
New REFCORP Proceeds(-)	-10.0	-25.0	-15.0				-50.0	-50.0
Insurance Premiums before deductions(-)	-2.1	-2.3	-2.7	-2.9	-3.1	-2.6	-15.6	-31.6
Deduct (+)								
FICO (CEBA) Interest	0.6	0.9	1.0	1.0	1.0	1.0	5.5	10.7
Sec. Reserve Credit	0.1	0.1	0.1	0.1	0.3	0.0	0.7	0.7
Defense New Bond Principal	1.7	1.7					3.3	3.3
Net Premium Income (-)	-1.4	0.4	0.1	-1.8	-1.7	-1.6	-6.0	-16.9
Proceeds from Receivers and Corporate-held Assets (old cases)(-)	-1.4	-1.4	-1.2	-1.0	-1.4	-1.5	-7.8	-9.7
Income on invest bal(-)	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.4	-1.1
Other Collections(-)	-0.4	-0.4	-0.4	-0.3	-0.3	-0.4	-2.1	-3.5
TOTAL COLLECTIONS	-17.0	-29.8	-16.5	-3.2	-3.6	-3.5	-73.5	-88.3
FSLIC/RTC NET OUTLAYS	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Repayment of Notes Issued after FY86	0.4	0.3	0.1	0.0	1.1	0.0	1.9	19.2
Balance of FSLIC Notes Outstanding (end-yr)	19.2	18.9	18.6	18.5	17.3	17.3	17.3	0.0
FSLIC/RTC Cash/Investment end-yr balances (9/30/88=$1.98)								
balance for cases:	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
balance for new fund:	0.0	0.0	0.0	1.0	2.1	3.2	3.2	8.8
SUMMARY OF ACCOUNTS AFFECTED								
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.9
Treasury Contribution to REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.0
Add'l FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	-7.9	-19.9
TOTAL BUDGET OUTLAYS	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39.9

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SENATE

[illegible]

Congress of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington DC 20515-6453
(202) 225-3621

FEB 24 1989

Honorable Jim Sasser
United States Senate
Washington, D.C. 20510

Dear Senator Sasser:

This is in response to your letter of February 24, 1989 in which you requested a revenue estimate of the President's proposal to reduce the tax rate on certain capital gain realizations.

The President's budget proposal would allow individuals an exclusion of 45 percent of the gain realized upon the disposition of qualified capital assets. Further, the maximum tax rate applicable to any gains on qualified assets would be 15 percent. The exclusion would not be a preference for purposes of the alternative minimum tax. Taxpayers with gain on qualified assets would be able to exclude 100 percent of the gain, if the taxpayer's adjusted gross income (calculated including 55 percent of the gain) is less than $20,000 ($10,000 for single taxpayers or married taxpayers filing separately). Taxpayers with an adjusted gross income less than $20,000 but who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion.

Qualified capital assets generally would be capital assets as defined under present law other than depreciable, depletable, and amortizable property used in the taxpayer's trade or business. Collectibles would not be treated as qualified assets. The special section 1231 assets, i.e., certain interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as qualified assets.

In addition, to be a qualified asset, the taxpayer must satisfy a holding period requirement. The asset must have been held for more than 12 months if the asset is sold in 1989, 1990, 1991, or 1992; for more than 24 months if the asset is sold in 1993 or 1994; and for more than 36 months if the asset is sold in any year after 1994.

The proposal would be effective for assets sold on or after July 1, 1989.

Congreſs of the United States
JOINT COMMITTEE ON TAXATION
Waſhington, D.C. 20515

FEB 24 1989

The table below provides our current revenue estimate of the President's proposal, subject to some qualifications which I discuss below.

The first line presents the revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent rate, for capital gains regardless of asset type, and assuming a one-year holding period and an effective date of sales on or after January 1, 1989. This calculation is based on baseline realizations from CBO's January economic forecast[1] and includes our estimate of the revenue effect which would result from a tax-induced increase in realizations. Consistent with recent economic analysis of capital gain realization behavior, our estimate reflects a larger short-run than long-run behavioral response.

The second line presents the estimated revenue effect which would result from moving the effective date of this proposal from January 1, 1989, to July 1, 1989. The third line presents the estimated revenue effect which results from excluding collectibles and depreciable property from the proposal. The fourth line presents the revenue effect of the lengthening, on a phased-in basis, of the holding period. The fifth line estimates the effect of providing the additional 100 percent exclusion to those eligible taxpayers with adjusted gross income less than $20,000.

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[1] The CBO baseline forecast differs from that made by OMB which forms the baseline for the Treasury estimate.

Projected Revenue Effect
(Billions of Dollars)

Item	Fiscal Years						
	1989	1990	1991	1992	1993	1994	1989-94
1. 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	
2. Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	
3. Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	
4. 3-Year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	
5. Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	
Total Revenue Effect	0.7	3.3	-4.0	-6.4	-6.9	-10.9	-24.2

We have not estimated the revenue effect for years beyond 1994 because the CBO baseline does not extend beyond that date. If the baseline realizations were to continue to grow at the same rate as between 1989 and 1994, we would estimate that the proposal loses revenue in the years beyond 1994. However, the magnitude of the losses would not increase smoothly, as the table above might suggest, because of the effect of the phase-in of the lengthened holding period.

The President's proposal lacks details which could materially affect our estimated revenue effects. For example, our estimate of the President's proposal assumes the enactment of very strong rules to prevent gains on collectibles and depreciable property from qualifying for the exclusion. Such rules have not yet been fully specified by Treasury. We are concerned that both C and S corporate structures could be used in some circumstances to qualify collectibles and depreciable property for the exclusion. In the absence of effective rules preventing this behavior, we would estimate a greater revenue loss.

The President's proposal does not detail how it will interact with the kiddie tax (dependents age 13 or under) or how it will affect the taxation of income of other dependents. It may be possible for high income taxpayers to shift assets with accrued capital gains to their dependents whose adjusted gross income is less than $10,000. Although our current estimate assumes very

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limited income shifting, substantial income shifting would increase the revenue loss.

The President's proposal does not specify certain aspects of the treatment that capital losses would receive. It is not clear whether a taxpayer will be permitted to deduct 50 or 100 percent of net long-term losses and whether the losses on collectibles will be unlimited or allowed to offset gains on qualified capital assets. For the purpose of this estimate we have assumed that the taxpayer is permitted to deduct 50 percent of net long-term losses and that losses on qualified assets must be netted against gains on qualified assets, while losses on non-qualified assets must be netted separately against gains on non-qualified assets.

The preceding discussion should not be construed as an exhaustive list of those areas which are unclear in the President's proposal. I included the above examples to suggest that our estimate of the revenue effects may change as the details are developed.

I hope this information is useful. If you have further questions, please call.

Sincerely,

Ronald A. Pearlman

Chairman SASSER. I will turn now to our distinguished ranking member who is representing Senator Domenici this morning, Senator Armstrong, for any statement that he might wish to make.

Senator Armstrong.

Senator ARMSTRONG. Mr. Chairman, I want to join you in welcoming our colleague, Secretary Brady, to the committee. We are eager to hear his testimony.

I would like to submit for the record the brilliant statement that Senator Domenici would deliver if he were here, in which he also welcomes the Secretary and comments on a number of matters which I think those who read the record will want to be aware of.

Then, before I yield, because I do not have a prepared statement of my own, I did not quite hear who it was that you were quoting as saying that cutting the capital gains tax would have little or no effect on the growth of the economy. Was that the Joint Tax Committee?

Chairman SASSER. Yes, it was.

Senator ARMSTRONG. OK. I was not aware that they were in the business of making such predictions, but I would like to come back to it at the right time.

Chairman SASSER. Well, I have attached that to my statement, Senator Armstrong, for your perusal, and you may find it interesting.

Senator ARMSTRONG. Good. I will look at that with interest, Mr. Chairman.

Thank you.

[The prepared statement of Senator Domenici follows:]

OPENING STATEMENT

SENATOR PETE V. DOMENICI

HEARING TO RECEIVE TESTIMONY FROM THE SECRETARY OF TREASURY

March 1, 1989

Mr. Secretary, it is a pleasure to welcome you in your first appearance before the Budget Committee. As the Chairman indicated, this committee is looking to you for guidance on the savings and loan crisis. However, I hope you will also share with us your general views on the budget and the economy in your role as the Administration's principle economic spokesman.

In his testimony here yesterday, Chairman Greenspan urged the Congress to move forward implementing policies to bring budget deficits down. We have one plan -- the President's plan.

Some don't think it is a real plan. I do.

Others don't agree with the President's priorities. I expect they will come forward with their own plan.

However, the point that Chairman Greenspan emphasized repeatedly was that whatever we do has to be credible. We have to put together a plan that represents real savings and offers the real prospect that under normal economic conditions -- steady growth and moderate interest rates -- budget deficits will come down.

Again, as the Federal Reserve Board Chairman said, it is not as important that we hit a specific dollar level -- we should try our best, of course. Rather what is important to financial markets is we take actions that cause investors to have a reasonable expectation that deficits will be dramatically lower in the future.

Let me comment on another issue of importance to the financial markets -- resolution of the savings and loan crisis -- and suggest what I believe to be the real concern of this committee. It is not just a matter of avoiding a sequester under Gramm-Rudman-Hollings or accommodating next year's cost within the budget resolution.

Our major concern should not be whether the Administration has changed its estimates of the cost of the plan. (Contrary to the press reports, I understand you have not). We should not even expend too much energy trying to determine how much it will cost, since there are far too many uncertainties to produce a solid estimate.

The FSLIC crisis presents a budget issue of extraordinary importance, whose effects will be felt for years to come. It undermines the basic premise of the federal deposit insurance funds, which is that the industry pays to insure itself. It forces us to turn to the taxpayers and changes all the rules.

We have heard a great deal about who shouldn't have to foot the bill. Not the healthy thrifts -- it's not their fault. Not depositors -- that's not fair. Not banks -- after all we didn't ask Ford and GM to bail out Chrysler. That leaves the federal taxpayers.

The real concern of this committee ought to be the long-term cost of this rescue operation to the taxpayers. We must balance short-term considerations about the budget with long-run concerns. And we must make sure that the taxpayers get a fair return on their investment -- namely, meaningful reform.

I hope that you will give us your views on the real costs of the FSLIC plan and how it will affect the budget over the next five years and in the long term.

In addition, I hope that you will comment on Chairman Greenspan's comments yesterday about the effect of a credible budget plan on financial markets and the economy. Finally, you might suggest your views on just how we get a budget done.

Again, let me say how pleased I am to welcome you this morning and I look forward to your testimony.

Chairman Sasser. Mr. Secretary, we will be pleased to hear from you now.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY OF THE TREASURY

Secretary Brady. Thank you, Mr. Chairman, Senator Armstrong, members of the committee. I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget.

I know you have already heard from Dick Darman and Michael Boskin, so in my testimony I will not repeat a detailed presentation of the budget.

However, I do wish to devote some time to discussing the financial aspects of our plan to solve the savings and loan crisis, which I know to be of interest to the Members of this Committee.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continuing vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, last week the Federal Reserve raised the discount rate one-half of 1 percent, to 7 percent. I would like to say a few words about that. First and foremost, the Bush administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. However, it is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapons in its arsenal to fight inflation to advance the cause of the long-term strength and vitality for the United States. The strongest weapon we in the government have to further the cause of long-term economic strength is deficit reduction. I know you share our view that we must all do our part. Even to delay action costs us—in terms of interest rates, jobs, the savings and loan crisis, and last but not least, the third world debt crisis.

Let us be frank with one another: We are constrained between revenue levels which are the result of the 1980 election which set forth President Bush's commitment to "no new taxes" and a Gramm-Rudman-Hollings maximum deficit level of $100 million prescribed in law. So, there are not funds to do all that we want.

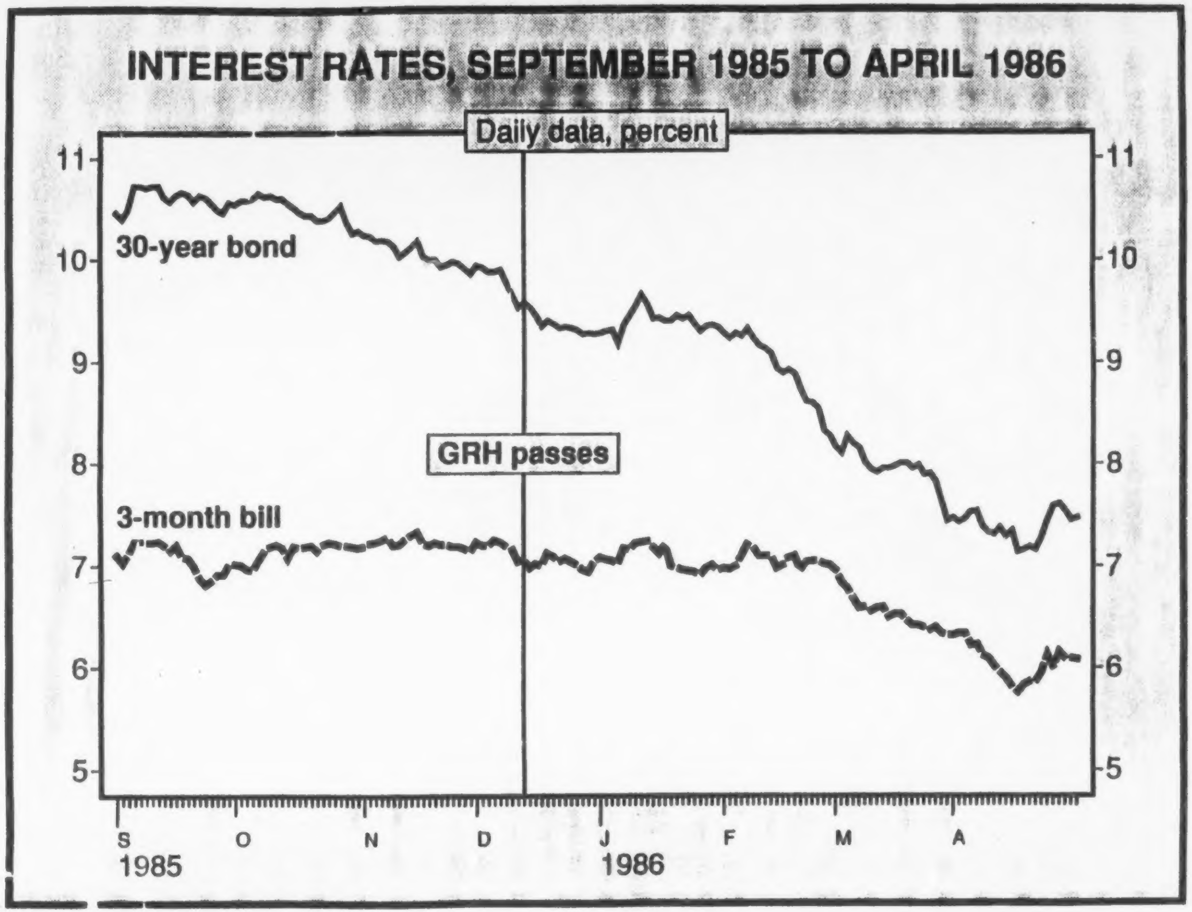
Stepping back from the roar of the budget discussions for a minute, one could say "this is where the country wants us to operate." In the end, the key is to have the American people say "they did what we wanted with what we gave them."

The Bush administration is absolutely committed to working with you to reduce the deficit. But some have questioned our economic assumptions. First, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias towards the so-called rosy scenario. In fact, in the last 7 years, the administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted economy. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8-percent growth rate. This is slower than last year's 3.3 percent drought adjusted growth rate. Our long-term forecast for a 3.2-percent sustainable growth rate is right in line with our experience over the past 40 years, during which the real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, may I make a few comments on interest rate assumptions. During my first year in business, 1954, 10-year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same 10-year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From 3½ months prior to the passage of this all-important fiscal legislation until 3½ months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes, I believe so.



INTERESTRATES, SEPTEMBER 1985 TO APRIL 1986

This would indicate to me that, while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the United States and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we do not reduce the deficit? No, I do not. Will they prove accurate if we do? Yes, I believe so.

Let me say a few words about the President's budget. I know that you have heard a great deal about the specific proposals from Budget Director Darman. However, I would like to reiterate a few key points. Within the confines of meeting the Gramm-Rudman target, the President has proposed budget priorities which, if adopted, will make a significant investment in our country's future.

I know you know them, but to repeat, his key proposals are:

He pledged $6 billion to winning the war against drugs; he kept his promise to emphasize education, not just through an increase in funding, but through programs which encourage excellence in education, awards to successful schools, a recognition program for superior students, a national science scholars program, and a plan to foster magnet schools; he addressed environmental issues, particularly that of acid rain; and proposed fully funding the McKinney Act and increasing overall funding to assist the homeless by nearly 30 percent over last year's levels.

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the tax code. He proposes a new, refundable tax credit of up to $1,000 for each child under 4 in low-income working families. This credit would be available to very-low-income families, in which at least one parent works, starting in tax year 1990, and will be expanded to include additional families in the following years. By this assistance, the President's budget provides vital support to families, while permitting families to make their own choices about child care that best fits their needs. The President further proposes to make the existing dependent care credit refundable. In its current state, the existing credit is of no value to lower income families who do not pay taxes and we propose to change that.

A few words about the savings and loan solution: The President's budget also contains the funding required to resolve the savings and loan crisis. It has three components. The first part consists of $50 billion to resolve currently insolvent institutions which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. And third, the plan provides $33 billion in financial resources necessary to put the S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of the Resolution Trust Corporation, for which the FDIC will be the primary manager, directed to resolve all S&L's which are now insolvent or become so over the next 3 years.

To provide the $50 billion in the RTC, we will create a new, separate, privately owned corporation, the Resolution Funding Corporation, which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

The Federal Home Loan Banks will contribute about $2 billion of their retained earnings—which are currently allocated to, but not needed by, the existing financing corporation (FICO)—plus approximately 20 percent of their annual earnings, or $300 million, in 1989, 1990, and 1991.

The S&L's will contribute a portion of their insurance premiums, and, if necessary, proceeds from the sale of FSLIC receivership assets will be used as well.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest on the REFCORP bonds will come from a combination of private and taxpayer sources: The Federal Home Loan Banks, beginning in 1992, will contribute $300 million a year; the RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and Treasury funds will be used to make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan—servicing the cost of the $40 billion in resolutions already completed by FSLIC—will also come from a combination of S&L industry and taxpayer sources:

FICO will issue bonds under its remaining authority and contribute the proceeds; the S&L's will contribute a portion of their insurance premiums; FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and, again, Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund, socalled SAIF, the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&L's insurance premiums and Treasury funds, as needed.

These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992–99 period and, in addition, contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Overall, the plan contains $33 billion in post-RTC funds from 1992 to 1999, to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will contain just under $9 billion at a minimum to support the healthy S&L's.

The net impact of the entire plan—which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be done, and providing for fully funded insurance funds for both commercial banks and thrifts—is $1.9 billion in fiscal year 1990 and $39.9 billion over the next 10 years, including 1990.

A word about capital gains: The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction in restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45-percent exclusion of long-term capital gains or a 15-percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000 if single. Such taxpayers would be eligible for a 100-percent exclusion—no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in place for 65 years. During this time, it was endorsed by Republicans and Democrats alike as an important means of stimulating investment. The Tax Reform of 1986 eliminated that differential in 1987. In my judgment, the benefits of a lower capital gains tax merit its reinstatement.

It is important for the long-term strength of our economy that our tax laws encourage savings and investment in entrepreneurial activities. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and short-term growth. Over the next 4 years, we propose to phase in a 3-year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus, we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus, we propose to restore this long-acknowledged incentive to American enterprise.

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation by U.S. industry. The current credit expires at the end of 1989. I think you will agree that it is time we stopped sending stop and go signals to the business community on the importance of research to our economic strength and future.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape, so that U.S. corporations can make their R&E plans with a longer horizon. With this purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

A few words about the international aspects of our budget discussions: Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but it is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work.

The new reality is that there are no more international boundaries when it comes to the flow of dollars—no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's financial transactions settle daily through the New York Federal Reserve.

Before the advent of the computer and the advent of instantaneous transfer of information and electronic funds transfers, this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The so-called CHIPS wire, which largely handles international transactions, and the Fed wire, which handles mostly, but not exclusively, domestic transactions. These figures which I am going to recite next have made in indelible impression on my mind, and I offer them up for your consideration.

Last month, on average, about $735 billion worth of transactions were settled every day on the CHIPS wire, and that level of activity is increasing on average at a rate of 25 percent per year. In addition, if you approximate the international transactions settled via the Fed wire, the other Federal Reserve settlement system, then there are about $1 trillion of international transactions settled every day on these systems. This amounts to $5 trillion a week, in other words greater each week than our yearly GNP.

Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987, the total stock of U.S. assets held by foreigners was almost $400 billion greater than the stock of foreign assets held by Americans. Ten years ago, this difference was $50 billion in favor of the United States' investments abroad. While one can have different views of how to interpret these numbers, one point is clear—we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficits. The tally of the world's opinion of our progress is registered every day through the Federal Reserve's wires. It is vital that we act decisively to preserve that confidence.

In closing, let me say that in case there is any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues—who met here in Washington the first week in February.

The G-7 is engaged in a team effort, as you know, to try to create world economic policy coordination, to provide a growing world economy. In that regard, from the United States' point of view, I have pressed them hard to stimulate their economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit.

They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process, very knowledgeable, and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the $100 billion target becomes too onerous, that we will move the goal line. I assured them on behalf of all of us, executive and legislative branches alike, that we are firmly and absolutely committed to meeting the deficit reduction target. I told them we will get there, one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal, and I appreciate the courtesy of letting me read my statement at this point.

Chairman **Sasser**. Thank you very much, Mr. Secretary, for your statement.

Mr. Secretary, I stated at the outset that one of my concerns about the FSLIC proposal was that the interest rate assumptions were overly optimistic. We heard yesterday from Dr. Greenspan and I did not come away from that hearing with any sense that we were going to see a down-turn of interest rates any time in the near future.

Now, what we have seen is that Federal fund rates have climbed steadily, by almost 3 full percentage points over the past year. In fact, just in the last half of last week, the Federal funds rate increased by half a percentage point, and the Federal Reserve discount rate was increased by half a percentage point as well.

Given that scenario, is it your view that it is realistic to assume steadily declining rates in evaluating the costs of this proposal?

Secretary **Brady**. Mr. Chairman, I can understand the line of questioning on our assumptions on interest rates as compared to what they are today. It is certainly a valid one. But I honestly believe, as I said in my statement, that if we enact deficit reduction in an orderly fashion, that does not mean we have to rush to it. All of these deliberations we are having here with you before your committee are important and should be carried forward.

But if we do enact a deficit reduction program along the lines of Gramm-Rudman, if we do meet that $100 billion goal, I do believe that interest rates are going to come down and that we can approximate the estimates that we have provided to you in the budget.

I would also say that, from 30 years in the business of watching interest rates, they can change pretty fast. We have seen them go up and I am convinced that we will see them come down and we do reach the Gramm-Rudman target.

Chairman **Sasser**. Well, Mr. Secretary, I fervently hope that you are correct in that assumption. But in the event that you are incorrect, have you done any interest rate sensitivity analysis at Treasury to determine what the additional cost of the proposal would be over the next 5 or 10 or 30 years, should the interest rates climb relative to OMB estimates?

Secretary BRADY. Mr. Chairman, subject to being corrected by the people with me, the statistic that sticks in my mind is that every 1 percent increase in interest rates has a $10 billion effect on the budget either way. If it goes up 1 percent, that is $10 billion more; if it comes down, that is $10 billion as well. I think that is correct.

Chairman SASSER. Well, I think you are correct. Some say $11 billion, but my real question is have they done any, have you done any analysis at Treasury, have you done any interest rate sensitivity analysis over the out-years to see what our cost would be if interest rates went up?

I understand, when we say the interest rate ticks up 1 percentage point, an additional $10 or $11 billion is added to our expense here on the national debt, and I am talking in terms of our expense on the FSLIC bailout plan. Do you know whether or not this study has been carried out, Mr. Secretary?

Secretary BRADY. Excuse me, I thought you were talking about the interest rate as a whole, as it affected the whole budget.

We have done some sensitivity with regard to the bailout plan. It is included in enough scope in the bailout plan, unless there is a wild breakout on the up-side. There is enough contingency in there to take care of interest rate increases. In the $50 billion that we have provided in the second step of this transaction, we really do not think that the resolutions will be $50 billion. In fact, if we resolve the book cost of resolving the institutions that are included in that group, it is only $18 billion. We raised that figure to $40 billion, in order to be safe, so there is another $10 billion in there if we should get an increase in interest rates.

Let me just check and see if we have done any sensitivity.

Chairman SASSER. If you have done so, would you be good enough to provide those to the committee for our analysis?

Secretary BRADY. We certainly will. It has been pointed out to me, Mr. Chairman, that there is an offset to the interest rates, too. If interest rates go up, the cost of buying the zero-coupon bonds for the REFCORP financing goes down, so it is not exactly one-to-one, but it is a big help.

Chairman SASSER. Now, with regard to another aspect of the plan, the Treasury plan assumes that there is going to be a deposit growth in the S&L industry of about 7.2 percent. That is going to be a deposit growth that is larger than the deposit growth that is anticipated for commercial banks, which as I understand it is predicted to be about 6.9 percent annually.

Considering what has happened to the S&L's in recent months, just looking at some figures here, last December there was a net deposit flow out of the S&L's of 8.1 percent, the previous month, $7 billion out of the S&L's, and some experts are predicting that the January deposit out-flow will reach $9 billion.

Now, given that scenario, Mr. Secretary, what was the basis on which we can expect S&L deposits to grow faster than those in commercial banks? If the deposits do not grow, of course, that is going to increase the cost of the plan.

Secretary **Brady**. Mr. Chairman, you used the figure of 6.9 percent for commercial banks. I think our figure is 7 percent for S&L's, so it may be more but it is probably so small that it is just very little more.

First of all, in answer to your question about the growth rate as a whole, which is a good one because we have had an out-flow in recent months, it is our conviction that that outflow is due to a large extent to all of the publicity, which is daily, black headlines in the paper about savings and loans problems which are uncorrectable, $90 billion problems, and it would be hard to measure this period as a normal period, while the focus of the press and the media in this country is on this particular problem.

It is our opinion that once a plan is adopted, the plan that we put before you or our plan amended, as we may negotiate, that this out-flow will stop, it will go back to the normal growth rate, which is what we have assumed here, and that normal growth rate is the nominal growth rate that is assumed for other budget calculations.

Chairman **Sasser**. Thank you, Mr. Secretary. I will yield now to Senator Armstrong.

Senator **Armstrong**. Thank you, Mr. Chairman.

In response to your opening statement, I asked about the source of your information that the administration's capital gains proposal would not have a significant effect on the economy, and I think I must have misunderstood, because I believe you cited the Joint Tax Committee, and I was surprised because I was not aware that the Joint Tax Committee was in that business. In fact, in reviewing what I believe to be the document, I do not see any reference to that.

My only reason for mentioning that while the Secretary is here is I would not want to leave him with the impression that that was the case, or, if it is the case, I would like to clarify it.

Chairman **Sasser**. Well, I am advised by the staff that I misstated. It is the Treasury's own 1985 study——

Senator **Armstrong**. Of 1985.

Chairman **Sasser** [continuing]. That shows that level of GNP would be only one-tenth of 1 percent higher after 5 years, if capital gains taxes were cut.

Senator **Armstrong**. I thank you, Mr. Chairman, for clarifying it. I wanted to bring that to the Secretary's attention. The Joint Tax Committee really is not in the business of estimating macroeconomic effects and, in my opinion, it should not be.

But I do think the Treasury Department ought to go back and reevaluate that 1985 study, because those of us who are interested in the President's proposal and believe in it are handicapped by the lingering impression that somehow it will not have its intended effect. My own opinion is that if we cut capital gains, it would be so well received that it would just unleash a whole torrent of creative economic activity. But may I say, Mr. Secretary, in a sense the ball is in your court on that and we need some help to clarify what I think is a mistaken impression.

Secretary **Brady**. Senator Armstrong, we will do that. It is my understanding that the study has had a different goal and aim and why not we try to separate the difference between the two studies and we will submit it to you and the chairman.

[The following was subsequently supplied for the record by the Treasury Department:]

We believe that the President's capital gains tax rate reduction proposal would have beneficial long-run macroeconomic effects.

First, a lower tax rate on capital gains that qualify under the administration's proposal would mean a lower cost of capital, primarily on corporate sector investment. Since these investments incur higher than average tax rates under current law, the proposed change would promote a more efficient allocation of capital among sectors of the economy, thus improving economic welfare and leading to higher growth.

Second, by lowering the cost of capital generally, the proposal would encourage more savings and investment, leading directly to greater capital formation and eventually to a higher rate of growth in the economy.

As an illustration of the long-run macroeconomic effects, the models and techniques used by the Treasury Department to evaluate the macroeconomic consequences of tax reform suggest that the administration's proposal could increase real national income by between 0.2 percent and 0.4 percent after the economy fully adjusts. This, in turn, would translate into a permanent annual increase in long-run tax revenues of about $3 billion to $5 billion in real 1989 terms. This revenue increase would be in addition to that reflected in the budget estimate.

Senator ARMSTRONG. While I have your attention on the capital gains issue, may I ask when they restudy that that they also take a look at the notion of indexing the bases, about which I have spoken to you privately, in fact I have spoken to everybody I could get to listen to the issue, both publicly and privately, a proposal which I think might have some very beneficial macroeconomic effect.

Could I now shift gears, Mr. Secretary, and say that I read in the press that you are catching a lot of flack and the President is getting a lot of flack for the FSLIC plan that you have sent up. I just want to note in passing that, by gosh, I think it is great that the administration, particularly the President, has guts enough to send us the plan early in the year. The easiest thing would have been to duck it and let 5 or 6 months go by and do nothing. The toughest thing was to send up a specific plan for everybody to shoot at, but I believe that the country is in your debt for getting us a plan, and if somebody wants to improve on it, I say let them come forward.

Could I now ask you to comment for a moment on the inflation issue. You mentioned in your prepared statement that you regarded that as a high priority of the Bush administration. The impression has been created that somehow there is a difference of opinion between the administration and the Federal Reserve.

Dr. Greenspan was here yesterday and testified that he was really targeting a zero inflation rate for some period down the line. He pointed out that it is hard to measure, but in effect said something fluctuating in the range of plus or minus 1 or 2 percent would be about what he thought was the right level.

Is it your representation that the administration is on that same wave length?

Secretary BRADY. Senator Armstrong, I am glad you brought this subject up, because I have been in meetings over the last couple weeks with the President and with Chairman Greenspan, and they do not sound to me like the same meetings that I see reported in the press. I said in my statement this morning that the Bush administration is equally committed with the Fed to fight inflation.

I did note that in different people looking at the same statistics can reach different conclusions from them, and that may be the source of our confusion in the press. So, I absolutely reaffirm the Bush administration's commitment to keeping inflation down and do so over a long period of time.

Senator **Armstrong**. If we could go back, Mr. Chairman, in whatever time I have remaining to the capital gains issue: As you talk to your counterparts overseas, how do you feel our capital gains structure affects our ability to compete in international markets?

Some people make the argument that our companies are greatly handicapped by the fact that we tax capital gains at all or that we tax them at rates that are so much higher than other countries. What are the economics ministers of other countries saying to you about that?

Secretary **Brady**. Senator Armstrong, I cannot add a lot to what you have already said. I think that the lack of capital gains taxation in other countries, they feel is an enormous advantage to them in building for the long term. As you know, in Japan, Germany, Korea, Taiwan, some of the countries that we are competing with in a struggle for world markets do have differing rates for capital gains than ordinary income, so to be honest with you, they think it is an advantage, so they do not talk to me about it very much, but the difference is there for all to look at.

Senator **Armstrong**. I think they are right.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Armstrong.

Senator Exon.

Senator **Exon**. Thank you, Mr. Chairman, very much, and welcome, Mr. Secretary.

There are a lot of things in the press today that are not accurate, I suspect, the least of which as far as accuracy is concerned is the job that at least this Senator thinks you are doing over there. Generally, I think you are doing an outstanding job under some extremely difficult situations, and I salute you for it.

Secretary **Brady**. Thank you.

Senator **Exon**. I have several questions I would like to go into. First, just a brief one. You are very familiar with the Exon-Florio law that was a part of the trade package last year. I am very pleased to see that the President has recognized this, and I believe that his appointment of the Committee on Foreign Investment in the United States is the organization responsible for the implementation of this law, at least drawing up the guidelines is an excellent idea.

When would you expect final regulations on the Exon-Florio law to be issued, then implemented?

Secretary **Brady**. Senator Exon, I cannot give you a definite date. I was just checking with one of my fellows that are here with me. We have been buried in this S and L crisis, and we are working hard on trying to come up with those regulations.

I can promise you it will be hopefully by the summer, and I hope we can do it within a couple months.

Senator **Exon**. Thank you, Mr. Secretary.

On another subject now, I would reference an editorial in the Wall Street Journal this morning entitled, "The Elderly's Tax Trap." We have been consumed with this thought of reducing the capital gains tax, and I would think a pretty good argument could be made for that with regard to expansion of business.

That means, then, I guess, that we did not properly consider this when we threw that hasty tax package together. And as you remember very well, one of the trade-offs there was that we were going to come up with a significant reduction in the overall rate and make it up in other places. How that is all going to balance out budget-wise, I do not know.

I am even more concerned about maybe getting started on what for a better word would be a tax reform package for senior citizens. I think they are really taking it right on the head on most of these tax things, and I would hope that I could work with you and your administration with regard to doing something about some of the gross inequities that I think have occurred to the senior citizens.

Unfortunately, when we talk about senior citizens, we say, well, let's take care of Social Security, let's protect that; that is number one. Then we take care of the health benefits, particularly Medicare, and to a less extent Medicaid. But we forget what we have done to them in the overall tax package.

Do you have some concerns about the present Tax Code with regard to senior citizens, and would you be adverse to at least consideration of a senior citizen tax reform package?

Secretary **Brady**. Senator Exon, we would be glad to work with you on trying to see how help can be made more readily available for our senior citizens.

I would point out that in our capital gains package, although some have scoffed at its import, we have included a zero capital gains for those who have incomes on a joint tax return basis of $20,000 and under. If this capital gains package goes through in the form that is suggested—that is not probably likely—but those people with incomes under $20,000 would pay no capital gains tax at all.

Now, I do not want to take a long time in answering your question, but we put this provision in here because in brainstorming about how we might put this thing together, I said, one say why don't you try and see what the revenue estimators come up with if we do this? And they took a crack at it and came up with the fact that there was an advantage to taxpayers of $20,000 and under, so we put it in the law. That is just one little step, but we had it in mind when we were thinking about capital gains tax reduction.

Senator **Exon**. Thank you.

My last question this round, Mr. Secretary, has to do with the statement that you made in your opening statement. I quote: "In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so."

Then at the end of the statement as you concluded, you said you thought that we would get there, to the Gramm-Rudman targets, quote, "one way or the other," end quote. I am sure you did not mean that, but I think some people have thought that we have gotten to those targets in the past "one way or another" and that there has been use of smoke and mirrors and creative bookkeeping. I am very afraid that we are going to get into that situation again.

Do you really believe that there is any chance that the Congress and the President will be able to get together to make a $40 billion or more reduction and avoid the sequester? It would seem to me that we are coming to the feeling around here that because we have that convenient escape hatch of the sequester, that why make the tough decisions—why don't we just blame that on the Gramm-Rudman-Hollings bill and let it go at that? I think that would be tragic, because there is a basic unfairness built into the Gramm-Rudman proposal that I think you are quite familiar with, and that is that it hits very hard a relatively significant percentage of the budget and could cause some great harm in lots of areas, including agriculture, and certainly our national defense.

When you say you want to get there "one way or the other", you mean realistically, do you not?

Secretary **Brady**. Senator, I think that statement, "one way or the other", is probably wide enough for different people to have different ideas——

Senator **Exon**. That is what I was afraid of.

Secretary **Brady** [continuing]. And I am not sure, with all due respect, mine are exactly the same as yours. But frankly, going to your main point, I am optimistic that between the executive branch and the legislative branch, we will get there. That optimism may be born of the fact that I have not been in this town but 5 months, but I see good will and understanding on both sides of the aisle that we are going to get there. Now, maybe when we get into the final details of this thing, we won't make it—but I have that optimism.

I also feel that finally, if we don't—and I think we will—that the matter of sequester is something that we might come to, but that is just my opinion. That would be my advice to the President; if you can't do it any other way, you had better do it that way—because I see the risks of international markets—this is from maybe the very narrow perspective of a financial man—but I see the risks of international markets giving us the chance to go through this process, but sort of having in the back of their mind that what they will really do is move the goal line when you get to the end of this thing. And that would be very disappointing to them, and I think it would be very adverse to the dollar, interest rates, the market, economic progress.

Senator **Exon**. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Exon.

Senator Grassley.

Senator **Grassley**. I am going to yield to Senator Nickles.

Chairman **Sasser**. Senator Nickles.

Senator **Nickles**. Mr. Chairman, thank you, and Secretary Brady, welcome. You have a very challenging job, to say the least, and I appreciate many of the comments you have made. I also compliment you for coming up so quickly with an S&L package.

But I am very concerned, and I would echo some of the statements that were made by the chairman of this committee, Senator Sasser, I guess, concerning interest rates and what that will do to the S&L package, but even more directly, what it will do to the budget and the budget deficit.

I asked a question yesterday, and we have reports—well, the budget deficit by OMB was estimated October 15 to be $146 billion; today it is estimated to be $163 billion, in February. That is 4 or 5 months, an increase in the deficit of $17 billion; and $11 billion of that was revision on interest rates. Interest rates, or interest costs, will be $11 billion more just because of the higher interest rates.

I mentioned to Mr. Greenspan yesterday my concern about that. I think the deficit is important for 1989 as well. So we have gone from $140 billion now to $163 billion, and if you take out the asset sales, it is $170 billion for 1989.

I also will tell you I think the Fed has shot down, if not torpedoed the budget for fiscal year 1990. We are going to wrestle around this committee and the Appropriations Committee—many of us serve on both—trying to save $1 billion here or there, or maybe put in some additional funding. But your estimate for short-term T-bills for 1990 is 5.5 percent. T-bills right now are at 9 percent, or approaching 9 percent. Long-term is above it, short-term are below it. That is a difference of 3½ points. You mentioned $10 billion per point. That is $35 billion. That is going to make it very difficult to get to Gramm-Rudman. And I want to do it; I want to reduce the deficit by $70 billion if we can. And I think we could, but I am afraid—the Administration wants to work on it, and I think the Congress wants to work on it—I hope that we do—but the Fed actions, if they continue a very tight monetary restraint, are basically going to blow any of these budget projections totally out of the water, and we will not be able to get there.

If we have an increase in interest expense between 1989 and 1990 of $30 billion, we are not going to get there. So I am very concerned. I mentioned yesterday that I am appreciative of the battle to fight inflation, and I sympathize with that, but I am not sure that just by increasing and drying up the monetary supply—and I have the figures on the growth of the monetary supply, and it has been very, very small in the last 13 weeks, minus in one category and even in M1 and minor growth in M2 and M3, below the targets in both of those for that last 13 weeks. If that policy continues, I am afraid that the rest of our efforts for deficit reduction or meeting the targets are going to be fruitless.

Secretary **Brady**. Well, Senator Nickles, perhaps I am not quite so pessimistic about the future of interest rates as others. I really do believe that the little chart I put at the end of my statement which shows how much interest rates came down both before and after you and Congress enacted Gramm-Rudman indicates some 300 basis points, or 3 percent in a 10-year bond, indicates the kind of movement you can get when people who are buying and selling securities are convinced that the Congress understands the problem as well as the Executive, and is moving toward a solution.

So these markets move; we are looking at them today, we are taking a picture today that is static. I think you put your finger on the right point, but I think that if we do get action on the budget, interest rates will come down.

Senator **Nickles**. Mr. Secretary, just a couple comments. Looking at the interest rates and bond yields for the last 10 years, I think you would agree with me this economic expansion that we have been enjoying really started probably in late 1982; that is also when we had the most dramatic reductions in prime rates and interest rates in our Nation's history.

I think that was caused not so much by just congressional action, but by Fed action; Fed action really constrained the growth of money for some time and put us into what I would say is a significant recession. That is where the budget deficit went up, and very significantly, was 1981, 1982 and 1983, because they overreacted in trying, in my opinion, to squeeze inflation. I hope that they are not doing the same thing. If they do, again I am afraid that we won't see a deficit reduction package; I am afraid that we will see deficits increase.

This little T-bill rate has been rising and rising rather dramatically, as you know, this past year, really starting last spring of 1988. I wanted to share that with you because, again, I think fighting inflation is important, but I would hate to see us just totally lose the budget battle both for 1989 and for 1990 and find ourselves in a very difficult situation in the future dealing with deficits.

Thank you.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you very much, Senator Nickles.

Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

There are a fair number of assumptions that have to be made in doing our planning, and yet forecasting—economic forecasting, at least—is considered by many more an art than a science. We do have to deal with a bunch of variables that, if wrong, if our calculations are wrong, could work very significantly against a target or an objective that we have set.

One of the questions that arises, particularly for New Jersey—I think you are familiar with New Jersey, Mr. Secretary—the savings and loan institutions in New Jersey on balance are pretty healthy. I have had questions raised to me about what happens to those healthy institutions when they have to carry the share of the burden for those who have performed badly—through, for example, increased insurance costs.

Is there anything that you see as an opportunity for them not to be penalized by the poor management or poor decisionmaking by those who failed or are on the verge of failing?

Secretary **Brady**. Senator, that is one of the ironies of the plan we put forward, there are many good savings and loans all over the country, and I agree with you, in New Jersey for the most part, we have a very healthy and responsible industry.

And when you get to a situation like this, the good have to pitch in in order to help solve the problem.

But to be specific in answering your question, it is our view that there is a big plus in this plan for the savings and loan industry, and that is that their cost of funds will come down because of the fact that the industry now will be regarded as being on a sound and safe basis, and investors will be willing to accept a lesser return because they are not worried about some of the things that they read in the press and hear in the news programs.

Our guess, Senator, is that that could be as much as 75 basis points, so that is something that I think will benefit everybody in the industry, and the healthy S&Ls will be able to take advantage of it as well.

Senator **Lautenberg**. The effects on financing for housing—with the thrift industry impaired as it is, do you see them able to continue their unique support of housing financing?

Secretary **Brady**. I do. Forty percent of the home loan financing in the United States is done through the savings and loan industry; they hold 40 percent of the home loan mortgages. That says that they are a very vital part of the industry. It also says there is 60 percent that is done elsewhere. So there is a healthy competition between S&Ls and other people who provide mortgages.

But basically what we see here is that sure, I am willing to admit that there will be a few less savings and loans, and I do not think it will be that big, but the ones that are remaining will be stronger. So I think your concern about the industry is well-founded, but in my opinion, we will have a sounder, safer, harder-charging industry when we get through.

Senator **Lautenberg**. Yes. The cost for therapy is going to be very significant, as we know, and I do not think yet fixed to where we can really get our hands around it.

I do not know whether you want to make any comments at this point about what ought to be done in the future to make sure that the part of the thrift industry that we are talking about here today is better managed. Does it require some form of regulation? We have seen the abuses; they get most of the attention. It is an industry that has been beset with poor management, whether intentional or otherwise.

Do you think that we ought to be taking another look at what the thrift industry's parameters might be in terms of their operations?

Secretary **Brady**. Senator, our plan does some amount to that, and of course, we would be grateful for any additional suggestions you might have. But we are proposing here—it is in the 330 pages of legislation that we have submitted—that the capital requirements for S&Ls go from 3 to 6 percent, those capital requirements to be in effect by the end of 1991.

Secondly, we are suggesting that those capital requirements ought to be on a risk basis. If you want to go into the business of financing windmill farms or herds of prize cattle, you use up a big bite of your capital to do that; whereas if you stay in the business of financing home mortgage, you get a much more favorable calculation of how your capital is used.

So we think that the increase in capital, number one; number two, the risk-based proposal that we put forward which penalizes risky investments and supports the more traditional uses that S&Ls have made of their money is going to be a big help.

Lastly, the FDIC, which will be the insurance now—we have separated that out of the Federal Home Loan Bank system, Senator, and put it into the FDIC—the FDIC is being given a fast whistle; if they do not like something they see going on in an S&L from an insurance point of view and from the protection of the Federal guarantee that we put forward here, then they can go in and blow that whistle, and say, "Cease and desist."

Senator LAUTENBERG. Can they—Mr. Chairman, just one more question—will there be selective rates based on some kind of a performance index calculated in here, anyway? Is there now an increase in premium for those institutions that violate any kind of rule, whether it is a capital rule or some kind of operating rule?

Secretary BRADY. My understanding of the details of that, Senator, is that the increase in premium, which is only from 20 basis points to 23 basis points, does not differentiate between that, but that they are hopeful that the risk-based capital will make up some difference.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Chairman SASSER. Thank you, Senator Lautenberg.

Senator Kasten.

Senator KASTEN. Thank you, Mr. Chairman.

Mr. Secretary, welcome.

I would like first of all, Mr. Chairman, to ask unanimous consent that a statement that I have prepared be inserted as an opening statement, along with a chart which accompanies it, entitled, "Capital Gains Rates and the Associated Revenue."

Chairman SASSER. Without objection, it will be included in the record.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

Thank you Mr. Chairman. And I want to thank Secretary Brady for his testimony before the committee today.

President Bush's proposal to reduce the capital gains tax will—once again—spark the debate over capital gains and tax revenues. This debate is becoming as predictable as the annual return of the seasons. We have been through the same debate year in, year out—and some people continue to refuse to learn from American economic history. One year ago, two years ago and even as far back as 1978, we have heard the very same argument against reducing the capital gains tax: that it would somehow lose precious tax revenues for the Federal government.

Skeptics said about the 1978 capital gains tax cut that it would do little for investment and do much to erode tax revenues. I remember then-Treasury Secretary Michael Blumenthal asserting that the proposed capital gains rate reduction from 50 percent to 28 percent would cost the Treasury over $2 billion in revenue. He said—and I quote: "The measure would do little for capital information and would waste revenues." End of quote.

Secretary Blumenthal objected. But in Congress, cooler heads prevailed—and the House and Senate agreed with my distinguished Wisconsin colleague, the late Congressman Bill Steiger, that it was time to cut the capital gains tax.

That was a cut in the tax on capital gains. Well, what happened? Did revenues go down? We've been through this time, and time, and time again—and you can go through the facts on this until everyone is blue in the face, but people just don't listen.

The fact is, taxes paid on capital gains increased from $9.1 billion in 1978 to $11.7 billion in 1979, and to $12.5 billion in 1980. That's a sustained three-year increase in revenues.

In 1981, we cut the top rate on capital gains even further to 20 percent, and capital gains tax revenues rose to $12.7 billion in 1981, $12.9 billion in 1982, $18.5 billion in 1983, $21.5 billion in 1984 and $24.5 billion in 1985.

Over the 7 year period, tax revenues to the Treasury were 184 percent higher in 1985 than in 1978. These are IRS figures. Nobody denies them. But a lot of people insist on ignoring them—and persist in making statements about revenues that are contrary to the fact. I ask unanimous consent that a table of capital gains rates and their associated revenue be entered at this point in the Record:

Mr. Chairman, allow me to quote from a recent Washington Post editorial on capital gains. Quote: "* * * revenues would certainly drop. Taken all together, over a period of years, the effect on revenues would be zero at best and possibly a substantial revenue loss." Does this sound familiar? It should—it's the same old discredited nonsense we've been hearing year in, year out since 1978.

The revenue windfall from a capital gains tax reduction will come from three sources. First, because the tax cost of selling equities will be cut in half, lower capital gains rates will lead to greater realizations by stockholders. These greater realizations will lead to permanently higher receipts from the capital gains tax. As the historical record shows, capital gains taxes paid continued to climb several years after the tax rate cuts of 1978 and 1981.

Second, a lower capital gains tax rate increases the value of stocks. Taxing capital gains at a high rate reduces the potential return on investment—and this future return translates into a lower price for the stock today. Conversely, a lower capital gains rate will increase stock prices, giving the Government more gains to tax.

Third, and most important, a lower capital gains rate will raise GNP. Even the Congressional Budget Office admits that—and this is a quote—"lower rates on gains could increase savings and capital formation and channel more resources into venture capital." End of quote. What CBO failed to recognize, however, is that this increased capital formation means that the entire tax base will grow even faster—resulting in an even greater increase in overall revenues to the Federal Government.

Most studies and available statistics on the revenue impact of the 1978 and 1981 tax cuts have focused solely on the realization effect and the subsequent increase in capital gains taxes paid. In doing so, they have neglected other important sources of revenue growth—and have, therefore, underestimated the potential revenue gains.

The capital gains debate has once again boiled down to a debate over the impact on federal revenues. The Treasury Department estimates that the revenue effect of the President's proposal will be positive during the budget period, as well as in the long-run. In addition, although not yet estimated, Treasury notes that it is likely that positive revenues from macroeconomic improvements will be significant over the long run. On the other hand, economists at the Joint Committee on Taxation estimate that the President's proposal will be positive in the first year—but lose revenues in the out-years.

Mr. Chairman, as we debate the issue of capital gains taxes and tax revenues, I would urge my colleagues to look at the historical record. Lower tax rates on capital gains actually increased tax collections—not only in the first year—but over a sustained period of seven years. We should put more faith in the weight of history than in the forecasts of economists.

CAPITAL GAINS RATES AND THE ASSOCIATED REVENUE

[In billions of dollars]

Year	Revenue	Tax rate (percent)
1968	5.9	26.9
1969	5.3	27.5
1970	3.2	32.2
1971	4.4	34.4
1972	5.7	45.5
1973	5.4	45.5
1974	4.3	45.5
1975	4.5	45.5
1976	6.6	49.125
1977	8.1	49.125
1978	9.1	49.125
1979	11.7	28
1980	12.5	28
1981	12.7	28
1982	12.9	20
1983	18.5	20
1984	21.5	20
1985	24.5	20
1986	46.4	20

Source: Research Paper No. 8801 U.S. Treasury Department.

Senator **Kasten**. Mr. Secretary, I would like to pick up on what Bill Armstrong and others were talking about earlier today with regard to capital gains tax cuts. The question we are dealing with here is: Are we going to look at history and see what has happened every time we have made these changes, going back to when my colleague Bill Steiger and I were working on this back in 1975, 1976, 1977, and 1978. Frankly, history is on our side, though some of the economists aren't. I think we ought to look at history to determine what is likely to happen, not to the economists predictions of, because the economists were wrong then, and I believe that they are wrong now—economists like those at Joint Tax who continue to make these assumptions.

If you go back and look at the historical record, in 1968, we had a tax rate of 26.9 percent, and capital gains tax revenue of only 5.9 billion. We increased the tax rate to 45.5 percent in 1972, 1973, 1974, and tax revenues went down. Revenues were lower; 4 or 5 years later, we went all the way down to $4.3 billion, with a 45-percent tax rate. Then we went up to 49 percent, and then beginning in 1981, 1978, 1979, we started coming down. And with a 20-percent tax rate, in 1986 saw revenues rise to $46.4 billion.

So we have cut the tax rate roughly in half, and we have increased tax revenues in the neighborhood of 185 percent from 1978 to 1985.

So history is on our side, and I think it is very important to recognize it.

I think you are right. You said to Senator Lautenberg or Senator Exon that the capital gains proposal of the administration is not likely to be signed off on by both houses of Congress this year in its exact form; but I believe that we are now developing a bipartisan, bicameral consensus. We are going to pass, if not this year, then next year, a capital gains reform. We will lower the rates. More and more people are recognizing the point that you made earlier—that we are no longer talking just about domestic economies here. People have their choice. They can invest in Wisconsin, or they can invest in Germany, or they can invest in Taiwan, or they can invest in Korea. They can make that investment decision relatively easily with regard to where they are going to choose to put their money. But if they put their money in Wisconsin or in New Jersey or anywhere in this country, they are going to be taxed not only on their income but also on their capital gains. And if they put their money in Germany or in Taiwan or in Japan or in Korea, they will not be taxed on the capital gains.

And the point we have got to recognize is how important this tool is in terms of our competitiveness around the world.

I note that we have made some progress. When Secretary of the Treasury Blumenthal was testifying against Bill Steiger's proposals in the late 1970's, he predicted revenue losses on this every single year. This year, not only do we have the dynamic estimate that you are working on—and I agree that we need more information, and I hope you will provide it—but this year, even Joint Tax says that we will cut rates, and revenues will go up in the first year.

Treasury says revenues are going to go up $4.8 billion in 1990; Joint Tax says they are going to go up $3.3 billion in 1990. So we are over a very important hump.

Joint Tax recognizes now that there is going to be a dynamic change, but they are saying people will shift, will just realize capital gains for 1 year, and that there will be no pickup in the outyears. They estimate a revenue loss of $4.0 billion in 1991. While Treasury estimates a gain of $4.9 billion.

The economists at Joint Tax, I believe, are wrong; and the weight of history is on our side.

In this mix there really are three different questions that we have got to deal with. Question number one is the issue of the holding period and how long, if it is going to be the phase-in that you are proposing, 1 year to 2 years to 3 years, or if you are simply going immediately to have a 1 year or 2 year holding period.

The next question is capital gains indexing. Bill Armstrong talked about that earlier. I think that obviously there has been a lot of discussion on it. And more and more people, particularly some of our friends on the other side of the aisle, are concerned about the issue of paying capital gains tax simply on inflationary gains. Bills have been introduced on indexing which are cosponsored by many Democrats.

My legislation, S. 171, the Entrepreneurship and Productivity Growth Act, both lowers the rate and partially indexes capital gains.

The third issue that we have got to deal with, I think, is the question of assets covered, the question as to how we define the job-producing kinds of investments that we want for capital gains. Both my plan and the administration's proposal have moved in the same direction. We have taken out art, we have taken out collectibles, we have taken out antique cars, we have taken out coins. There are some questions, though, in terms of real estate; there are some questions as to what kinds of investments are we talking about; how are we going to define equity investments that in fact should qualify for preferential capital gains treatment.

I would just like for you to touch on the question of indexing, the question of the holding period, and lastly, the question of assets covered as we work to put together what I believe will be a capital gains reform bill, if not in this year, in this Congress.

Secretary **Brady**. Senator Kasten, going at it backwards, as to how you pick the mix in coming up with a proposal that does the most toward generating long-term growth, you stare at the figures and try and figure that out. But our thought was collectibles, old fire engines and clocks, nice as they are, do not add to long-term growth, and therefore they should not be part of any proposal which frankly does upset a compromise that was made in 1986 about the revenue code. But does it make sense, on the other hand, to try and pick a few items which we know will make a difference, and say to people who are considering this proposal we recognize the compromise that was made in 1986 but now let's get on to another job, which is trying to get people's horizons out in terms of investment in the United States, so we can compete with other countries abroad, who are starting to eat our lunch in the trade area.

So what we did was to say, well, the place where you can have the most effect is in securities, because that will affect the security holders, and if the security holders are affected, then the people who run various companies will be affected shortly thereafter.

So we picked securities as the main focus of our first attack on this problem. Now, in the first sense, you say well that is a Wall Street giveaway. That is wrong. What this may very easily do is to slow down the turnover in Wall Street as people start to hold for a longer period of time. So although it benefits the people who are willing to hold it long-term, I am not sure it is going to benefit Wall Street. I think you will hear about that when we start talking about this in a more serious way.

So our attempt was to try and aim at that point of the economy that will make the most difference about getting this country aimed out at long-term planning.

You mentioned depreciable assets. We did not put them in for the reason that there was strong criticism of the fact in the 1986 tax law that a combination of being able to charge off depreciable assets against your income during the period that you held those, and then selling them as a capital gain, provided a windfall for that kind of investor. So we said let's not get into that argument again; maybe there is something on that side. So we zeroed in on this particular part of it.

Second, indexing is another way of going at this problem. I think that with all due respect to Senator Armstrong, the thing I would say on the other side of that is it is too complicated. The average guy, who probably does not have a tax advisor, does not understand exactly how it works—and I must admit in my own case, it is not too simple to understand unless you get somebody who is familiar with the law to explain it to you. So I think it goes back in the direction of making the Tax Code harder to understand for the American people and therefore making them think less of the Tax Code.

So we have thought about indexing. We think it is a good idea. We just think this particular plan is simpler, and will be better received.

With regard to the phase-in, our plan contemplates a 1-year holding period from 1990 to 1992, a 2-year holding period in 1992 and 1993, and after that a 3-year holding period. Why did you do that? Well, because I do not think you want to jar the sensibilities of everybody who is investing in the United States.

Right now, people's tax horizons who are making investments is 10 minutes. If you invest in a stock worth $50 a share, and half an hour later it is worth $57, sell it. It does not do you any good to wait and go on, unless you think it is going to go up further. But there is no incentive on your part to think long term as an investor.

So we said, as we shift this thing, let's not do it overnight. Let's do it over a period of time that gives people's investment philosophies a chance to change. I will admit to you in passing that it also has an effect on the budget, which is not the reason we did it, but we do have budget considerations this year, so it worked—excuse me, I am going past my red light, Mr. Chairman——

Chairman **Sasser**. Go right ahead.

Secretary **Brady** [continuing]. It does affect the budget discussions we are having, so we said that is good, too.

Senator **Kasten**. Mr. Secretary, my time has expired. Actually, that red light is mine, not yours.

Secretary **Brady**. I thought it was mine.

Senator **Kasten**. But I will come back and ask a couple of additional questions on the next round.

Secretary **Brady**. I thought maybe the chairman had turned it on.

Chairman **Sasser**. No; that red light is a result of the 4-minute question that was propounded to you, Mr. Secretary.

Let me ask just a few questions here, Mr. Secretary, and take you back, if I may, to the FSLIC problem and the savings and loan problem.

The administration has consistently said that the plan that it has advanced—and I do commend the administration for offering a plan, and my questions this morning are directed at trying to ascertain what we perceive to be the true cost of the plan. But the administration has said consistently that the plan will cost the taxpayers only about $40 billion over the next decade.

Now, I think we agree that there is no doubt that the FSLIC fund cannot cover the cost under current policy. We have some problem, Mr. Secretary, with the $40 billion figure over the next decade. What is your estimation of the cost to the taxpayers over the next decade? Do you agree with that $40 billion figure?

Secretary **Brady**. Mr. Chairman, let me say first of all, I think this is a healthy discussion we are having on this particular subject, because it is complicated and is subject to differing views.

When you talk about cost, it is not our position that this only cost $40 billion. That is the budgetary impact of the scoring that OMB has given us on our plan. Obviously, depending how you look at it, the plan itself in terms of the whole economy is more expensive. You start off with $50 billion that we are borrowing, the $40 billion that have already been dedicated, and then some funds that we are adding to make sure after we get through that we do not do this job on ourselves again. So there are various different ways to look at it.

If you look at the disbursement line through 1999, and then there are some OMB figures that go out further than that, which I do not have with me this morning, that is $126 billion.

So it depends on how you look at it. Again, I do not mean to run on, but one of the reasons we did it the way we have done it is to bring this problem into focus, make it traceable. What we have said is here is what it costs in capital, here is what it costs in interest. It is right up front.

Now, I would submit to you that that is not the way we look at a new Trident submarine; it is not the way we look at a host of other programs. If we had looked at the Kennedy Moon shot, which cost $30 billion, as stated to the public, and added in the interest and other charges the way we have done it here, it would have added another $90 billion to the cost of that project—so instead of people saying the Kennedy Moon shot cost $30 billion, they would have to say it was $120 billion.

That is a perfectly decent way to look at it. But we have sort of a double standard. Sometimes we put in all the attendant financing charges; other times, we do not. I think both ways of looking at it are things that ought to be brought out so the American people can have a look at it.

Chairman SASSER. Well, Mr. Secretary, I understand that, but we have got some very bright people here, working in the Senate, as you know from your years of service here, and they sat down with OMB people and, using the administration's own numbers and assumptions furnished by OMB, they came up with a different story.

Let me run through this with you, and you might get your pencil there and total this up and tell me where we are wrong, if you can.

Taking the 10-year numbers right off the detailed tables provided as background by OMB, we find that you have to add the taxpayer funds provided to cover the shortfall of the FSLIC fund for past and future commitments. And we find that that totals about $37.9 billion for past and future debts. Then we add to that taxpayer funds for payments of interest on the $50 billion in bonds that are off-budget. That interest, paid by the taxpayers, as we calculate it totals about $22 billion.

Now, FSLIC is broke, so we have to add to FSLIC about $8.8 billion worth of taxpayers' funds as we calculate it, reserved for future FSLIC problems.

Then we add an additional $19.2 billion in tax dollars to provide cash to pay off all notes issued on past obligations that have already been scored on budget.

But since $9.5 billion worth of notes issued in the first quarter of 1989 are already reflected in the original $37.9 billion that I talked about at the beginning of my statement here, you have to subtract this amount so you do not double-count these cash needs.

Now we subtract the draw-down of FSLIC's cash reserves available at the end of fiscal year 1988. They had $1.4 billion in reserves at the end of 1988. This is cash on hand and available to FSLIC to meet its obligations, and that reduces the amount of taxpayer cash that is needed.

When we add all of that up, we come out with a 10-year total of about $76.7 billion. If you could follow all that, Mr. Secretary—it took me a while to get it all together myself, I must say—what is your reaction and do you disagree, or do you agree?

Secretary BRADY. Mr. Chairman, I will be frank with you, just having the numbers read to me is not going to provide me with the basis to comment on it. I would be glad to take those figures if they are in some written form, or as they come out of your exposition this morning, and comment on them.

As you know, we have provided 333 pages of legislation, 10-plus pages of detailed statistics from the OMB, with the idea that nothing is held back. I would like the opportunity to take your figures and comment to you at some later date. I cannot comment off the top of my head.

Chairman SASSER. Well, I think that is fair, and I think you ought to have the figures and be allowed to study them so that you can comment on them.

But I would just say in passing before going to Senator Lautenberg that it totals almost $77 billion, and that is about $37 billion, what is generally perceived or interpreted by the administration's statements as to be the taxpayer funds that will be involved.

[The following was subsequently supplied for the record by the Treasury Department:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

April 5, 1989

Dear Senator Sasser:

We appreciate your interest in understanding specific aspects of the Administration's proposal to reform and finance the recovery of the thrift industry. This letter responds to the questions that you asked Secretary Brady to answer after his testimony before the Senate Banking Committee on February 22, 1989.

Your first question asked that the Treasury verify the accuracy of a $76.8 billion cost figure for the first ten years of the Administration's financial plan for resolving the thrift problem. This figure was derived by your staff from the detailed budget outlays table attached to Secretary Brady's written testimony by adding the ten year totals of FSLIC/RTC net outlays ($37.9 billion), FSLIC notes outstanding ($19.2 billion), estimated Treasury payments on the REFCORP interest ($22 billion) and the balance in the SAIF fund ($8.8 billion) and subtracting notes issued in 1989, which are included in the $19.2 billion figure ($9.7 billion) and the use of FSLIC's own cash for case resolutions ($1.4 billion).

The $76.8 billion figure is the estimated amount of appropriations that the Treasury will need to pay for the FSLIC's shortfall and the interest on REFCORP bonds over the first ten years of the plan. However, the estimated net budget outlay for the ten-year period as shown in the table will be $39.9 billion. Net budget outlays are used by the OMB to determine whether Gramm-Rudman-Hollings sequestration will be necessary. It is the outlay figure which we believe best measures the impact of the plan on the general public over the next ten years, because it represents the net amount of additional Treasury financing that must be obtained. Unlike the appropriations measure, the outlay figure excludes technical steps necessary to assure certain intragovernmental transfers of money to the FSLIC/SAIF.

Your second question related to the plan's sensitivity to changes in interest rates.

Because the plan, in the first three years, calls for the purchase of zero coupon Treasury securities as well as the sale of REFCORP bonds, there is a minimal sensitivity to interest rate changes during this time. An increase in interest rates would mean that less money would be needed to purchase the zero coupon securities because of the compounding of interest at a higher rate. This would more than offset the increased interest cost of the REFCORP bonds in the first few years. For example, a 200 basis point increase in interest rates over the Administration's assumptions in 1990 would increase the total interest cost on the REFCORP bonds outstanding by $500 million and on FICO interest and FSLIC notes by another $500 million; but the cost of purchasing the zeros would drop by $1.7 billion for a savings in 1990 of $700 million.

However, the OMB has projected that if interest rates were 200 basis points over the Administration's estimates, the cost of the plan would be $3.9 billion higher over the 1989 to 1994 period and $10.7 billion higher over the 1989 to 1999 period.

Your third question referred to the sensitivity of our financial plan to a change in the growth rate of deposits at savings and loan institutions.

Our plan assumes that deposits in savings and loan associations will grow at an average annual rate of 7.2 percent. If over the next few years the thrift industry's annual deposit growth rate is considerably lower than 7 percent, it will have very little impact on the Treasury's cost estimates. Total deposits at year-end 1989 were about $1 trillion and whether the average growth rate is 4 or 7 percent over the next few years will not drastically alter the amount of premium income paid by the industry.

However, we believe that once all the insolvent thrift institutions are resolved, and the public regains confidence in the thrift industry, that the deposit growth rate should return to the level achieved in the past.

If an institution pays an average annual interest rate of 7 percent on its deposits, interest-credited alone could cause the institution's deposits to grow by 7 percent a year.

Moreover, when insolvent institutions are resolved through liquidations and mergers or when branch locations are closed, the deposits do not just disappear. Most of these deposits are placed either in other thrifts or in banks; and the institutions that accept the deposits pay deposit insurance premiums on them.

We hope that our responses not only answer your questions but also help to allay any concerns that you have about the plan. Please let me know if there are any other questions that you or your staff would like us to address.

Sincerely,

(Signed)

John K. Meagher
Assistant Secretary
(Legislative Affairs)

The Honorable James Sasser
United States Senate
Washington, DC 20510

($ in billions)

FSLIC & RTC ACCOUNT	FY89	FY90	FY91	FY92	FY93	FY94	1989-1994	1989 1999
DISBURSEMENTS								
Old Cases & Other Expenses								
Admin and misc exp	0.3	0.3	0.3	0.3	0.3	0.2	1.6	2.8
Notes Issued	− 9.7						9.7	9.7
Interest on Notes Outstanding	1.4	1.5	1.1	0.9	0.8	0.7	6.4	9.2
Repay notes issued prior to FY87	0.0	0.0	0.2	0.0	0.2	0.0	0.5	0.5
Assistance Payments	5.2	4.4	3.8	4.2	3.4	2.9	24.0	28.8
Liquidations	1.0						1.0	1.0
Total Old Cases and Other Exp	17.7	6.2	5.5	5.4	4.7	3.8	43.2	52.2
New Cases								
Assisted Mergers	5.0	12.5	8.5	1.2	1.8	1.0	30.0	44.0
Liquidations	5.0	12.5	8.5	1.2	1.8	1.0	30.0	30.0
Total New Cases	10.0	25.0	17.0	2.4	3.6	2.0	60.0	74.0
TOTAL DISBURSEMENTS	27.7	31.2	22.5	7.8	8.3	5.8	103.2	126.2
COLLECTIONS (-)								
FICO proceeds (CEBA)(-)	-3.8	-3.3					-7.1	-7.1
New REFCORP Proceeds(-)	-10.0	-25.0	-15.0				-50.0	-50.0
Insurance Premiums before deductions(-)	-2.1	-2.3	-2.7	-2.9	-3.1	-2.6	-15.6	-31.6
Deduct (+)								
FICO (CEBA) Interest	0.6	0.9	1.0	1.0	1.0	1.0	5.5	10.7
Sec. Reserve Credit	0.1	0.1	0.1	0.1	0.3	0.0	0.7	0.7
Defense New Bond Principal	1.7	1.7					3.3	3.3
Net Premium Income (-)	-1.4	0.4	0.1	-1.8	-1.7	-1.6	-6.0	-16.9
Proceeds from Receivers and Corporate-held Assets (old cases)(-)	-1.4	-1.4	-1.2	-1.0	-1.4	-1.5	-7.8	-9.7
Income on invest bal(-)	-0.1	0.0	0.0	0.0	-0.1	-0.1	-0.4	-1.1
Other Collections(-)	-0.4	-0.4	-0.4	-0.3	-0.3	-0.4	-2.1	-3.
TOTAL COLLECTIONS	-17.0	-29.8	-16.5	-3.2	-3.6	-3.5	-73.5	-88.
FSLIC/RTC NET OUTLAYS	10.7	1.4	6.0	4.6	4.7	2.3	29.7	+ 37.
Repayment of Notes Issued after FY86	0.4	0.3	0.1	0.0	1.1	0.0	1.9	+ 19.
Balance of FSLIC Notes Outstanding (end-yr)	19.2	18.9	18.6	18.5	17.3	17.3	17.3	0.
FSLIC/RTC Cash/Investment end-yr balances (9/30/88=$1.9)	$	$1.9B − 0.5 = $1.4						
balance for cases:	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.
balance for new fund:	0.0	0.0	0.0	1.0	2.1	3.2	3.2	+ 8.
SUMMARY OF ACCOUNTS AFFECTED								
FSLIC/RTC Net Outlays	10.7	1.4	6.0	4.6	4.7	2.3	29.7	37.
Treasury Contribution to REFCORP Interest	0.5	1.4	1.6	0.9	0.8	1.1	6.3	22.
Add'l FDIC Collections	0.0	-0.8	-1.6	-1.7	-1.8	-1.9	7.9	-19.
TOTAL BUDGET OUTLAYS	11.1	1.9	6.0	3.8	3.7	1.5	28.1	39

+ 37.9
+ 19.2
− 9.7
− 1.4
+ 8.8
+ 22.00
7[illegible]

Chairman **Sasser**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Mr. Secretary, do you have a convenient index that measures the impact of GNP growth on Federal revenues—we talked about 1 percent being worth $20 billion to $24 billion—is that something that somebody has got readily? Am I about right, $20 to $24 billion?

Secretary **Brady**. Over time, it can add up to that, Senator.

Senator **Lautenberg**. Okay. I just want to use that as the basis. The growth rate last year overall was forecast to be 3.8 percent. This morning, we heard that growth quarter to quarter last year was only 2 percent.

Is there any alarm that we ought to sense here, or that we ought to be concerned about, in that decline, because GNP growth was fairly robust in the first part of 1988.

Secretary **Brady**. Senator, there is always concern when you see figures that do not agree with your forecasts. But I have to tell you that the intense preoccupation, not on your part, but with statisticians with this, to me are not as important as looking at a continuum of figures that have been achieved during the last 4, 5, 6, 7, 8 years. So if it actually turned out to be the way you have stated it, it would produce such a revenue loss—maybe not in 1 year, but over a couple years.

I fundamentally believe we will reach the targets that we have had before, and as I mentioned in my testimony, the people who put these revenue estimates together underestimated the growth in 4 years and overestimated it in 3. So it is as wide as it is long.

Senator **Lautenberg**. So the depth or the height of the swing could make a huge difference.

Secretary **Brady**. Exactly.

Senator **Lautenberg**. Do any of your people have an average interest cost for the debt outstanding that the country now has? Is there such a thing?

Secretary **Brady**. Oh, I am sure there is such a thing. I do not know whether we have it with us or not.

Senator **Lautenberg**. Because I would be very interested in that.

Secretary **Brady**. We would be glad to provide that to you.

[The following was subsequently supplied for the record by the Treasury Department:]

The average interest rate on the public debt was 8.987 percent as of March 31, 1989.

Senator **Lautenberg**. Yes, because just in quick arithmetic that you and I could share, if it is somewhere in the 8, 9 percent range, and interest rates increase 1 percent, and you are not reducing your debt, it is increasing, then if it is 8 percent, and it is a 1 percent increase, you have about 11 or 12 percent increase in cost. The interest bill each year now is about $160 billion. You have got a kick-up of fairly significant proportion if you have to go up 12 percent.

That is just an observation. If we could get that, I would be interested.

I am not a scoffer, Mr. Secretary. I have too much respect for you and for the administration to scoff at anything you propose.

You and I know each other, and your record before and since your Government service is a very distinguished one. But I am a skeptic about the result of changes in the capital gains tax.

Of course, there are two ways to reduce that. One is to increase the income tax rate, which none of us want to see, and that would automatically reduce the capital gains rate if we held it firm.

I do have to be not only skeptical but cynical when you talk about a joint income tax return that is $20,000 or a single person's return at $10,000, looking for capital gains advantage. That is not much of an incentive for them to hold their investments long-term, I would have to tell you.

I am concerned about how we define productive investment. We have kind of narrowed it down, have we not, Mr. Secretary, to securities.

Secretary BRADY. Senator, let me just make sure that—I misspoke earlier, to some extent. It also includes houses. That is a big part of it, I should have mentioned earlier, and I did not mean to mislead you.

Senator LAUTENBERG. Right. And I assume that that would be the principal asset of someone in those earnings levels. But even at that, $10,000 individual income, it is awfully hard to buy a house, and awfully hard to have held a house over the years. That is just below the poverty line for a family income.

But if we define "productive securities," are we talking about new issues, or are we talking about old issues; issues trading on the exchanges or over-the-counter? Is there any differentiation there?

Secretary BRADY. My understanding is that there was not, that it was both for new and old issues.

Senator LAUTENBERG. Okay. So an LBO purchase would qualify just the same as any other. Or in fact, does the purchase of an existing traded issue add to the productive incentives for our country?

Secretary BRADY. I think it does. I will skip the LBO point, because I think you and I have concerns about LBO that we have talked about previously, although they are in the basket.

I think giving this break to existing securities makes sense, too, Senator, in the sense that those securities perhaps will sell at a higher price and will incent the managements in those companies to act in a way that will try to collect in their investor base those people who will stay with you for the long term.

Can I just go back a second—and I do not make a big point out of this below $20,000, because I take your point that those are the people who are least able to afford to invest. But it arrived in our proposal simply because we said, well, let's just see what it looks like when you do it. And our revenue estimators came up with the fact that it would be of benefit to $20,000 and under taxpayers in the amount of $300 million a year. And actually the joint committee which has been referred to earlier pegs this figure at $500 million.

So my feeling was, well, include it. Now, I do not know exactly what the mix is between houses, whether they might buy a few shares in a mutual fund, or whatever. But why not put the break there and see if there is a way of indicating that this is an idea that is good for everybody.

Senator LAUTENBERG. Mr. Chairman, if I might have the indulgence of you and Senator Kasten for one last observation and question.

Mr. Brady, if we have a 3-year waiting period, once again drawing on our personal pre-Government experience, each of us, it is hard to imagine an incentive for 3 years that would have me at the end of the year—and I know you are a pretty clever fellow when it comes to investing—at the end of the year saying no, I am going to wait 2 more years because my tax rate on this is going to be almost halved from 28 to 15 percent.

Doesn't that seem like an awful long time to believe that someone is going to hang in there for 36 months when this is fully matured, to wait for a reduction, when the calculation you have to make, is my investment going to be worth as much 24 months hence, using my 1-year example?

Secretary BRADY. Well, in my opinion, what we ought to do is try and incent people in that direction, Senator. It, to me, is something that we ought to work on over the next years that we are all going to be working together, not only in regard to this particular proposal we have made, but try and get people thinking that they should invest it long-term.

And in my opinion, if I were thinking about it, then I would say, look, I do not want to pick a security, I do not want to listen to the guy who is going to come in and tell me earnings are going to jump up 10 percent in the next quarter, and that I had better watch it night and day and make sure that I am timed into that, and I can go boom. I think we ought to push people toward thinking about—I am going to invest in a company that is going to put long-term plans down, try to make—you know the argument; I will not go through it—cheaper products with more quality at a price, and therefore take back some of the markets that our foreign competitors have taken from us.

I am not sure it is 100 percent right, but I think we can change the way American investors think about this thing if we work on it.

I wish I had invested in ADP about 15 years ago and held onto it.

Senator LAUTENBERG. I wish I hadn't sold.

Chairman SASSER. So do I, Mr. Secretary.

Senator LAUTENBERG. Thank you very much.

Chairman SASSER. Senator Kasten.

Senator KASTEN. Mr. Chairman, thank you.

Mr. Secretary, I am upbeat and optimistic, as I said before, and even more upbeat and optimistic after the last set of questions. I think we are seeing more and more people focusing on this capital gains question, and I think we are going to be able to develop bipartisan support for some kind of a program.

We have talked about indexing, we have talked about holding periods. We have just talked more about holding periods, and we have talked about assets covered. Is it fair to say that you and others who are going to be involved in this debate are prepared to work with us and others here in terms of trying to develop not only the best proposal, but also a proposal that can pass?

Secretary BRADY. Yes, sir, it is.

Senator **Kasten**. I want to clarify one important point about the President's capital gains estimate and the budget targets and how they relate. My understanding is that the $5 billion revenue gain which is in the budget from the capital gains tax reform is in effect over the line, or not counted, in order to meet the Gramm-Rudman target. Is that correct, and could you explain that?

Secretary **Brady**. Well, I could, but I think you have done a pretty good job. The President's budget proposal meets the Gramm-Rudman targets without including the benefits of a revenue increase derived from capital gains. If you put that revenue increase in as well, then the deficit goes down another $4 or $5 billion.

Senator **Kasten**. And the next step is basically what the President's proposal is, in effect only focusing on what we call the "unlocking effect"—just the change in capital gains realizations from the reduced tax rate. But I think both of us would agree, and I feel very strongly, that there in addition is a macroeconomic growth effect. In other words, if we are seeing more people invest in job-creating kinds of opportunities, we are going to see income taxes go up from those corporations, we are going to see other kinds of revenue growth.

Now, the President's budget message says—and I quote—"Although not yet estimated, it is likely that the positive revenues from macroeconomic improvements will be significant over the long run." I want to concentrate just on the "although not yet estimated"—it implies that it will be estimated.

Are you going to be coming back to us and explain how you would go beyond just this $5 billion gain in the first year and estimate the macroeconomic positive effect of a capital gains reform if we are able to pass one?

Secretary **Brady**. Senator, there is a big argument in the tax-estimating fraternity as to whether you ought to include those dynamic effects that you have talked about.

The Treasury Department estimators did not include those dynamic effects. If they were included in the way you described, it would add. But I wanted to make sure that when we did this that the revenue estimators felt free to tell their friends and whomever they talked to that they were not pressured by the Treasury to come up with these figures. We did not ask them to change their minds about anything. We said here is there proposal, including the one for taxpayers under $20,000—what do you think about it? What does it show?

So although I might have personal feelings in this matter which are very close to yours, we did not try to impose them on the estimators inside the Treasury.

Senator **Kasten**. So that the words, "although not yet estimated," do not imply that you are going to come back to us with an estimate, or in fact, are you going to come separately and say, in our best judgment, this is the kind of dynamic positive effect that a tax rate reduction on capital gains could have, although we are not counting this in the estimates that we are giving you officially. Is there some way that we can start to get you to tell us about the dynamic rather than the static estimates of this change?

Secretary **Brady**. Senator, this is a subject that I would like to study and think about a little bit before I answer that question. As

I say, personally, I might agree with you. I am new enough at the job to leave the Treasury estimators alone, doing what they are doing right now, and I do not deny for 1 minute that what you say would produce higher revenues.

But we now have estimates that these fellow came up with by themselves I have never met them or talked with them. We just simply gave them the proposals to see what they would come up with. That was important that we do it that way.

Senator **Kasten**. Finally, opponents have criticized the capital gains proposal, saying that it benefits only the wealthy income groups. This has been the criticism of capital gains tax reform, again, going back to the middle 1970s, and everybody has charts, $100,000 income or more will benefit, $200,000 or more will benefit.

I think it is important to point out that we have got 47 million Americans who are now owning equity as stockholders; their median income is $38,000. The average worth of their stock is $6,000. So we are not talking about only very high-income individuals; we are talking about middle America; we are talking about people all across this country. And we are talking about, I think, a very important issue and a very important positive kind of a change.

Has OMB or Treasury prepared any distributional analysis that answers some of the criticism about the impact of a capital gains tax cut on upper-income individuals—and how they will pay more capital gains taxes after the tax rate is cut?

Secretary **Brady**. We do not have that information with us this morning, and I am not sure we have it period, but could I get back to you with the exact answer?

Senator **Kasten**. I think it would be helpful to us as we start to engage in this debate. I think it is going to turn out not only that the distributional analysis will be a little bit more complex than has been outlined, but it also might be interesting to think in terms of by taking out the works of art, the antiques, the collectibles, the others, which in effect are shelters, and that the high-income groups might be participating in more than others, and therefore by making the change toward equity investment, we might be also taking a step in answering part of this distributional question. I hope we could include that in any kind of work we do. That would be really tough to separate out, but we ought to maybe make a try at it.

Secretary **Brady**. I am not sure we have the facts base to do that, but again, let me get back to you.

[The following was subsequently supplied for the record by the Treasury Department:]

The distributional effects of capital gains tax rate reductions are often shown without the important effects of changed taxpayer behavior, principally increased realizations. "Static" distributional effects for a single year show that a large percentage of the rate reduction benefits high income taxpayers. The "static" distributional effect is misleading in the case of capital gains for two reasons.

First, many taxpayers realize capital gains infrequently, and thus their incomes are higher than average in years of realizations. Thus, capital gains realizations tend to be concentrated among high income families partially because infrequent realizations push some low- and moderate-income families temporarily into higher income brackets. Tax return information following the same families over a 5-year period show that one-half of families realizing capital gains during that period realized gains just in 1 year. Only one-in-five of these families realized gains in more than 3 out of the 5 years.

Second, if tax changes resulting from induced realizations are taken into account along with static changes in tax, the restoration of a capital gains tax rate differential results in a slightly progressive redistribution of taxes. As shown on the attached table, before making adjustments for conversion and targeting but taking into account taxpayer behavior, the President's basic proposal would increase by 9.2 percent capital gain taxes for all taxpayers with over $50,000 of adjusted gross income. The President's proposal would reduce capital gains taxes by 3.1 percent for taxpayers with less than $50,000 of income.

DISTRIBUTION OF NET CAPITAL GAINS, AND TAX LIABILITY UNDER CURRENT LAW AND AN ACROSS THE BOARD RATE CUT [1]

[Calendar year 1991, in billions of dollars]

Adjusted gross income class under current law	Capital gain realizations		Tax on capital gains		
	Current law	Rate cut[1]	Current law	Rate cut[1] "Static"	Rate cut[1] "With behavior"
Less than $10,000	19	22	0.9	0.3	0.7
$10,000 to $19,999	7	10	.9	.4	.7
$20,000 to $29,999	8	12	1.3	.5	1.2
$30,000 to $49,999	15	29	3.3	1.4	3.6
$50,000 to $99,999	24	54	6.3	2.6	7.5
$100,000 to $199,999	23	50	6.4	2.7	6.9
$200,000 or more	86	172	22.2	10.5	23.7
Total	182	349	41.3	18.3	44.3

Department of the Treasury Office of Tax Analysis, March 31, 1989.

[1] The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

Senator **Kasten**. Thank you.

Mr. Chairman, thank you.

Chairman **Sasser**. Thank you very much, Senator Kasten.

Mr. Secretary, just two or three additional questions. You propose to finance the S&L bailout proposal off-budget, and I certainly understand the budget constraints that you face. As you know, we face them here. And you indicated earlier on what these constraints were—as far as the administration is concerned, a constraint of the no tax pledge on the part of an incoming President caught between the constraints of the Gramm-Rudman-Hollings law.

Let me just ask you this question point-blank. Do you see any reason other than the Gramm-Rudman-Hollings deficit targets that we ought to put this proposal to refinance FSLIC off-budget?

Secretary **Brady**. Yes, I really do. And if I may, Chairman Sasser, just let me mention two. There are a great many, and I know we have had this discussion backward and forward, and I do not mean to repeat myself.

But number one, we are getting a contribution from the industry toward the REF Corp bonds of some $300 million a year. If you take that $300 million and divide it by the number of bonds outstanding, which are $50 billion, that contribution comes to a contribution of 60 basis points. So we are getting 60 basis points from the industry as a contribution to the REF Corp financing.

So if our estimate is accurate—and there are others that are higher and some that are lower—of 25 basis points for the cost of doing this off-budget, then it seems to me that the contribution which our plan sets forward by putting it both on-budget and off-budget is greater than the incremental expense that might come from financing the REF Corp bonds in the way we have suggested, of zero coupon bonds.

However, I think there is an overriding consideration that we have here, and again, I am not in any sense saying that any one of the questions that have been raised this morning are ones that should not have been raised.

But what we propose to you in legislation that covers 330-plus pages is a way of collecting the industry—not only the S&L industry, the banking industry, the regulators—in other words, the total composite American group that is dealing with this problem—in a way that they agree to and a way that they will behave.

We are scooping money out of the Federal Home Loan Bank system. We are increasing premiums on savings and loans and banks. We are doing all manner of things in terms of increasing capital ratios, increasing power of the FDIC. That is a system which working with you and others took us 3 or 4 months to come by.

So we are not saying this is the only way. We are saying it is the best way, we think, but we make the point very strongly that we have got everybody collected, moving forward on this point, more or less together. There are some who will argue that the Federal Home Loan Bank system should not report directly to the Treasury, and others who say that new capital requirements should not be brought in 1990. That is the to and fro of legislation, and we understand it and applaud it.

But the long answer to your question is no, we did not do it to make sure that the budget was not severely impacted. We note in passing that that does not turn out to be the case; that we do not ask Congress or the executive branch to make enormous choices at this point in time when we have plenty else to argue about between whether we want to pay for savings and loan restitution or a new Trident submarine or new funding of the McKinney Act or whatever, and we think that is a plus as well.

So I am sorry for the long answer, but that is my answer.

Chairman SASSER. Well, these are not questions that lend themselves to easy, quick answers. But just to follow up if I could, is there any reason why we couldn't get the savings and loan industry to make their contribution and still do the borrowing on-budget and get the savings as a result of the borrowing on-budget?

Secretary BRADY. I do not have such a plan in mind.

Chairman SASSER. Other than the Gramm-Rudman-Hollings strictures.

Secretary BRADY. Senator, you know, we did our best in coming up with the plan we came up with. I do not mean to repeat myself, but it is pretty detailed, and we have an enormous amount of figures to back it up. It is all laid out there, and if the industry has got a better way of going at it, we would be glad to look at it. But we think this is the best we have been able to come up with.

Chairman SASSER. I operate, as you well know, under the same problems that you do with Gramm-Rudman-Hollings, et cetera——

Secretary BRADY. Probably worse.

Chairman SASSER [continuing]. Yes, I would say a little worse, as a matter of fact—and we are looking at any way we can to try and save a few dollars here. So that is why the idea of having this thing on-budget has some attraction to it. I do not say that the attraction is irresistible, but it does have some attraction to it.

Many of the deals worked out by FSLIC last year have been criticized, rightly or wrongly. They offer the new owners little or no incentive to turn the S&L's around since they are guaranteed a return on their non-performing assets.

In other words, as far as these new buyers are concerned, it does not matter if interest rates are going up or down; they will stay in business with their Government finances.

My question is have you or your colleagues at Treasury thought of any method of putting proper incentives in place for these existing deals to encourage the thrift institutions covered by assistance agreements to work hard to turn themselves around—I am going to ask that same question of Danny Wall tomorrow when he appears here.

Secretary BRADY. Senator, I think really I should defer to Danny Wall. He did those deals. We do not have the details of them inside the Treasury. Part of our plan as announced was to provide proper information to the newly created FDIC organization to take a look at those deals.

My guess is the incentive you are talking about is that if the newly financed resolutions make money, the people who put the money up are going to benefit from it. So I think that they will be incented to do a better job.

Admittedly, it looks like they put up a little money for a lot of gain, and I cannot argue about that; you are dead right. But they cannot make a lot of gain unless the S&L is doing the right thing.

Whether or not those deals were the deals that should have been made, I think you should ask Chairman Wall. I will say in his defense he did not have any cash to do the job with. He had to use interest rate guarantees and some of the things that you have referred to for his resolutions.

Chairman SASSER. Yes, but one of the weaknesses in Chairman Wall's defense—he was appearing before the Banking Committee last summer—is that he was assuring us that things were okay, when indeed they were not okay. In his defense, some of us knew those assurances could not have been valid that he was giving us last summer.

We have been joined by Senator Symms, who has a question, Mr. Secretary.

Senator SYMMS. Thank you, Mr. Chairman.

Mr. Secretary, I apologize that I was slow getting here this morning. We have a conflicting hearing in the Finance Committee that I had to be at this morning.

I had an interesting experience this morning as a participant on "It's Your Business," the U.S. Chamber of Commerce weekly television program, which Dr. Lesher is on, and I am normally on the same side as Dr. Lesher on that program. But this morning I found myself on opposing sides of a point of view, and the question I want to ask you relates to that.

Chairman SASSER. Excuse me. You were opposed to Dr. Lesher?

Senator **Symms**. Yes—which was a rare occasion. That is why, Mr. Chairman, I knew you would be surprised.

Chairman **Sasser**. Well, I am shocked. [Laughter.]

But go ahead.

Senator **Symms**. I had to make the observation on the television program that we have come full circle now; that Lenin said the capitalists would sell the rope to hang themselves with, and now the U.S. Chamber of Commerce is saying we should provide the credit for it.

I just want to ask you a question relating to untied loans, Mr. Secretary, which I have discussed with you before. Our trading partners, particularly the Japanese and the Germans, have continually been expanding their lending to the Soviet Bloc, which then the Soviets are able to take in hard currency and use to build up Kam Rahn Bay or Nicaragua or Angola with the money. Then we have to pass a larger defense budget to be able to meet the threat along the Pacific Rim or in Africa or wherever.

I know it is difficult to tell people what they should and should not do—but is it possible in those international meetings, like the Toronto Summit meeting last year, and you will have an upcoming summit with the economic leaders of these other countries in April and July, to continue to raise this issue? Can we make any headway on this, to try to explain to our trading partners that the old U.S. taxpayer ends up guaranteeing these loans in the end, like they had to do in Poland and like they are doing now for the S&L's, and like we did on the farm credit situation two years ago. It just seems like an endless problem that we keep kicking back to the taxpayer.

Is there anything you feel we can do to force our adversaries in the Soviet Union to choose between "guns and butter" so that we really can expect to see "peristroika" and "glasnost."

Is there any way we can get that done, instead of simply letting our allies give them money, which then means we have to have a bigger Navy to offset what they do out in the Pacific?

Secretary **Brady**. Senator Symms, I can only tell you that the point of view that you have expressed was expressed directly to the G-7 colleagues at the time of the World Bank meeting this last September. I was not present at last year's Toronto summit.

I would be less than honest with you if I described their reaction as respectful, and a certain amount of denial that this was going on. But I think perhaps the best we can do is to keep talking about it, because as you just pointed out yourself, we do not have a system whereby we can exert undue influence on the banking systems of those countries that are involved and lending on an untied basis to the Eastern Bloc and the Soviet Union.

I am not trying to take their side of the argument, but I can see it in their eyes when I talk about it. They ask us to understand that these people are right next door to them, and that they will have commerce with them every day on a tied basis, and the banking systems are intertwined, and you know the whole story. And they refer to some of the things that we might do with countries such as Mexico, to try to help and aid them, which is not totally in their interest.

So the argument goes back and forth. All I can tell you is that it was brought up, it was brought up in a formal meeting, it was brought up in a way that was as forceful as I could be without being unmindful of their particular interests. I do not have a solution better than that. I think you are right to keep raising it. I just hope that it sort of gets into their thinking, and perhaps we will make some headway that way.

Senator **Symms**. Well, thank you very much, Mr. Secretary. I appreciate the chance to bring that to your attention once again, and I thank you for continuing to do what you can do.

It just begs common sense for us not to try to get the connection between the dollars that we have to spend to provide for our own security and the cost of a blue water navy, and then if we are actually, through our friends and allies or our banks or their banks, helping to finance our adversary.

It just does not help the Russian people, that is my point. I want to do things that increase consumer activities in the Soviet Union for the Russian people so that they will be more willing, I think, to work with us in the future and reduce the tensions in the world. I think that is what we would all like, and I appreciate your efforts, and I appreciate that you did raise that issue with our allies.

Thank you, Mr. Chairman.

Chairman **Sasser**. Thank you, Senator Symms.

Mr. Secretary, we should have quit while we were ahead. I think we are going to continue to keep going here; we have a "revolving door".

Let me just ask you one quick question, really by way of statement. We discussed a moment ago my doubts—and I hope my doubts are wrong—about whether or not S&L deposits are going to grow at the rate that the Treasury plan is indicating.

You said, I think, in response to one of Senator Lautenberg's, or perhaps Senator Exon's questions, that one of the things we needed to do was to squeeze down these high fliers.

A large part of this current crisis was built on rapid deposit growth, with some of these high flier S&L's offering exorbitant rates to attract the capital. Then, of course, they used it for a lot of purposes that turned out to generate enormous losses.

But if we are going to count on high growth in S&L deposits to help us with this plan that is being advanced, it appears to me that as we squeeze down these high fliers—and they ought to be squeezed down; I think we have got to do that—it is going to occasion shrinkage in deposits rather than growth as they bring down the rates with which they attract deposits.

Do you have any comment on that? It appears to me we are inconsistent here; there is an inconsistency in the plan that I have difficulty swallowing.

Secretary **Brady**. Mr. Chairman, let me just mention again that the growth rate we put forward, which is in the 7-percent area in rate of nominal growth, does ignore this last year where we had this enormous publicity, and not only just publicity, but difficulty in the industry. So it is not surprising in our mind that the growth this last year would not match that figure.

We do feel it will be present in the future. We are not saying at the same time that there will be exactly the same number of

S&L's. I think the industry will shrink some—not an enormous amount, but some—as the strong S&L's get stronger and the weaker ones are resolved or decide to merge or decide they cannot meet one requirement or the other.

But our basic assumption is that there will be money in the system, in the S&L system in the first instance and in the commercial banking system as well for home mortgages. I think the direction in which you are headed is will the home mortgage market be vibrant, strong, and able to provide to the American people sufficient funds so that the average guy can go finance a house. That is our goal as well. And it is our guess that if we get this plan or this plan, as you and others might make changes in it, on the road and going, that that is exactly what will happen.

Chairman SASSER. Senator Grassley.

Senator GRASSLEY. I assume from the chairman's comment when I walked through the door that I am not particularly welcome right at noon here.

Chairman SASSER. On the contrary—you are always welcome, Senator Grassley. We were just thinking about the lunch hour when we saw you walking in.

Secretary BRADY. Senator Symms mentioning Idaho french fries.

Senator GRASSLEY. Well, anyway, sir, thank you for being tolerant. I do not think my questions are particularly tough or will take that long.

But I want to express to you first of all the fact—and I do not think I am speaking just for Iowa, but obviously, my mail in Iowa is what I have to pay a great deal of attention to. I do not think my people support the taxpayer bailout of FSLIC. Now, that does not mean that I am not going to support it, because I think that part of it deals with an understanding of what we are trying to do and what the complications are if we do not.

But I just want you to know that the public seems to be unsympathetic to the crisis of the thrift industry, and along that line I have received dozens of letters from constituents expressing antagonism toward a taxpayer-financed bailout of the savings and loans, and there is considerable of that in your plan. And of course, the basis of this frustration may be the generalized approach that the media coverage has given to the gross fraud and mismanagement of selected institutions.

So I just wonder if you have thought about it from the standpoint of public relations, what plans the administration has to build public support to assist FSLIC and its member institutions.

Secretary BRADY. Senator Grassley, you have stated the case eloquently, in my opinion. People do not like the idea of the fact that they are going to have to pay something to resolve the S&L crisis. The strong S&L's in the industry do not like it. But what we have tried to do is come forward with a balanced approach which, as I mentioned when you were out of the room, collects the industry, collects the regulators, collects the Congress and the administration, and move forward toward solving this plan so we can put it behind us.

The unescapable fact is that we have a problem. The best we can do is try and solve it; and, as Senator Sasser said, solve it quickly, and go on and make sure we do not do it again.

But I do not have an answer to the outrage that some of your constituents in Iowa have over this. I can fully understand, and I have heard a lot of it myself.

Senator **Grassley**. Along these same lines, the most prominent concerns of thrifts in my State and I suspect also around the country is the lack of public confidence in the system, and of course, the result has been even in my State, the result of the loss of face, sort of slow run on deposits of uncertain customers who withdraw their funds.

Now, I know you are going to say that the administration's plan is to restore this faith in the savings and loan industry and to stop this slow run. I have heard you addressing that. But has it been successful? Do you see it as successful, and are you seeing this as enough, or do we have to do yet more to stop this slow run?

Secretary **Brady**. Well, I do not think the statistics are here for me to—I mean, we do not have them currently in the last month or two because they have not come in yet for me to assure you that people are not worried, and there are not still those who are taking their money out of savings and loans.

All I can tell you, Senator Grassley, is that we have been on every nightly news show, and one of the top three or four stories for 2 or 3 months—I say "we," the problem—it has been in every newspaper; you can find it either on the front page of the business section or the front page of the paper itself—we do not see a run on deposits at this particular point in time. So I think generally speaking, the American public are satisfied that we are at the business that we should be, which is taking care of this problem and moving on.

But to give you precise figures, I cannot do it this morning.

Senator **Grassley**. And I suppose it is still another month before we will know those statistics?

Secretary **Brady**. Well, they come in from time to time, and frankly, it is in the banking system, it is in the Federal Reserve; it is not inside the Treasury. So I think those questions probably should be more effectively addressed to the people who have the banking industry statistics before them on a monthly basis.

Senator **Grassley**. Let me bring up the tax benefits awarded to purchasers of insolvent thrifts. The tax advantages obviously were significant since the Federal Home Loan Bank Board raced to close those dozens of thrifts that they did in the last days of 1988 before the tax breaks were to be reduced.

What is the cost to the Treasury of these tax breaks?

Secretary **Brady**. Well, we do not know yet, because it includes various different mixes and matches of various parts of the resolutions.

As I am sure you are well aware, Senator Grassley, that was done inside of FSLIC, which is an independent agency. We will have those figures. They are booked; the cost of the resolutions, as Chairman Wall estimated them, were booked in the 1989 budget, and they are included in our budget figures which have been presented by OMB for the 10-year and 30-year periods going forward.

Senator **Grassley**. Well, then, when do you think we will have those figures because I think it is pretty important we know, as we are talking about further restructuring.

Secretary **Brady** [conferring with staff]. I think I am getting the usual answer, Senator, that (a) it is a difficult problem, which you know, but (b) that we hope to have those figures within the next month—at least a guesstimate at them.

Senator **Grassley**. So we will have them before I am asked to make a decision on this plan?

Secretary **Brady**. That is what I would deduce from what I just heard.

Senator **Grassley**. Okay. And then, I guess I would have to ask is you anticipate restructuring down the road here, now with these reduced tax breaks, do you anticipate that to have any negative impact on restructuring?

Secretary **Brady**. Senator, I am not sure I understand your question precisely. I think the fact that some good part of the tax benefits died at the end of 1988, so I believe instead of 100 percent of the losses being forward now for the year 1989, 50 percent, and that will reduce the attractiveness, and the whole tax breaks of that nature go out at the end of this year, so I would think that that would have an effect—but we will have the cash coming in, hopefully, from this plan, if approved by Congress and signed by the President, so that that method of resolving the problem ought to take over.

Senator **Grassley**. Mr. Chairman, thank you very much.

Thank you, Secretary Brady.

Secretary **Brady**. Thank you.

Chairman **Sasser**. Thank you very much, Senator Grassley.

I have some questions here for Senator Exon, Mr. Secretary, which will be submitted for the record, and would ask you to respond in a timely manner. And speaking of Senator Exon, I want to associate myself with the remarks he made at the outset of his questioning. I think you are doing an excellent job at Treasury, and many of us are reassured to have you at Treasury during this very difficult time, what with the FSLIC problem, the Third World debt problems, trade deficit problems, et cetera. We are delighted to have someone of your background and evenhandedness handling the affairs of our Nation from the financial standpoint.

Before I close these hearings, I would just like to reassure this audience that my questions about the proposed FSLIC plan do not reflect adversely on that plan, and that we believe that the Government should stand fully behind its commitments to ensure depositor funds in the Nation's savings and loan institutions.

I say that in case someone wants to run out of this room and take their funds out of the S&L's because I asked some questions about the plan of the Secretary of the Treasury.

If there are no further proceedings, I declare these hearings closed.

Thank you, Mr. Secretary.

Secretary **Brady**. Thank you, Mr. Chairman.

[Whereupon, at 12:15 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR EXON TO SECRETARY BRADY AND THE RESPONSES

FOREIGN INVESTMENT DATA "BRYANT BILL"

Question 1. I realize that you oppose the Bryant bill on foreign investment reporting and disclosure. Is there a middle ground on the issue of monitoring foreign investment which you could support? Could you for example support an independent *confidential* audit by the General Accounting Office of our government's foreign investment data gathering to determine where information gaps exist? Could you support a coordination of State estimates of levels of foreign investment?

Answer.

—We are reluctant to consider measures which might raise questions about the confidentiality of data the government collects on foreign direct investment.

—The lapse in confidentiality would have negative repercussions on foreign investors and on all government data collecting efforts.

—The Department of Commerce is exploring ways to provide more detail by industry and state in foreign investment. Treasury and Commerce are studying other information on foreign investment that government agencies collect.

—We expect these efforts to improve the data without putting at risk its confidentiality.

SAVINGS

Question 1. Yesterday, the Chairman of the Federal Reserve warned that the Federal Government's debt and deficit situation poses a serious risk to the economy because of the low level of domestic savings.

One of the promises of the supply side experiment was an increase in personal savings. That experiment has clearly failed. Savings as a percentage of personal income dropped from 7.5 percent in 1981 to 3.2 percent in 1987. What will be the trend for 1988 and 1989? How important is personal savings to the Nation's economy? What steps would you recommend to increase the personal savings rate? Did President Reagan and the President abandon individual retirement accounts (IRAs) before its ability to increase personal savings could be measured?

Answer. The personal saving rate is influenced by a number of factors in addition to fiscal policy. Among them, the large number of baby-boomers in their prime spending years, as well as the very sharp gain in the stock market, are both believed to have exerted a downward influence on the aggregate personal saving rate during the early 1980's.

Since 1987, there has been a fairly significant rise in the personal saving. The personal saving rate increased from 3.2 percent in 1987 to 4.2 percent in 1988 and has risen further to 5.7 percent in the first 2 months of 1989. While special factors have contributed somewhat to the gain so far this year, it appears nonetheless that the overall trend is upward.

Saving is important to an economy since it is the source of funds for investment. High rates of investment encourage the productivity growth necessary for gains in the standard of living. However, in assessing the impact of saving on the economy, it is better to focus on total national saving, of which personal saving is only one component. The most important action the Federal Government can take to raise national saving is to reduce government dissaving, as represented by the Federal deficit. The President has proposed a budget which would result in a narrowing of the deficit by some $70 billion in fiscal year 1990 and which provides a path for closing the deficit entirely by 1993. Such a reduction would not only meet the Gramm-Rudman-Hollings targets, but would free up $70 billion in resources next year for productive investment by the private sector.

—It is important that reduction in the deficit be achieved through spending restraint, and not through higher taxes. The impact of an increase in taxes would be similar to a continuation of the deficit in draining resources from the private sector.

There is still considerable effort being devoted to measuring the impact of tax-deductible IRA accounts on personal saving. The evidence so far is inconclusive. The administration is giving careful attention to this and other possible saving incentives, but will only be considering programs consistent with the goal of reducing the Federal deficit.

One measure affecting personal saving has already been proposed by the President. We believe the reduction in the capital gains tax included in the administration's fiscal year 1990 budget will stimulate both saving and investment without reducing Federal revenues.

Increased saving and investment are top priorities of the administration. Substantial deficit reduction through spending restraint is the most important contribution we can make toward the goal of improved U.S. saving.

FOREIGN INVESTMENT

As the United States has gone deeper in debt in the private and public sector, our Nation has increasingly relied on foreign sources of money. In 1987, it was reported that foreign interests purchased 20 percent of the bonds sold by the Federal Government. What is your best estimate of the trend for 1988 and 1989?

I understand that the key question around the Treasury Department when bonds go on auction is "Are the Japanese in the market?"

At what point would you as Treasury Secretary be concerned about the absolute level U.S. dependence on foreign funds to finance the national debt?

The attached table shows the increase in foreign and international holdings of marketable Treasury securities on a quarterly basis for 1987 and 1988. It also shows total Treasury issuance of marketable securities and the increase in foreign and international holdings as a percent of total issuance. The percentages are for the most part in the single digit range and in any case significantly less than 20 percent.

Furthermore, to put foreign and international ownership of the public debt in perspective, as a percentage of the public debt it has declined from 17 percent in December 1978 to the 11 to 13 percent range since 1980 and is currently approximately 13 percent.

With respect to Treasury auctions of securities, we welcome foreign participation. Broad participation leads to more cost efficient financing.

It should be pointed out that the Treasury is, in effect, first in line to tap loanable funds in U.S. dollars and thus can borrow the funds it needs. The reason is that U.S. Treasury securities do not carry any credit risk and benefit from the largest and most liquid financial market in the world.

With respect to U.S. dependence on foreign funds, as long as the U.S. runs a current account deficit in our balance of payments, this will be offset by a net capital inflow (including official transactions) of equal amount. In other words, the dollars that foreigners are accumulating have to go somewhere, though not necessarily into Treasury securities. Foreign preferences will dictate where foreign investment will go. If foreign funds do not go into Treasury securities but into other investments, domestic investors will purchase the Treasury securities.

In other words, the better way to look at it is not that the U.S. Government is dependent on foreign funds to finance its budget deficit, but that the U.S. current account deficit is financed by a net capital inflow. The current account deficit and the capital inflow are opposite sides of the same coin.

INCREASE IN FOREIGN AND INTERNATIONAL HOLDINGS OF MARKETABLE TREASURY SECURITIES AS A PERCENT OF TOTAL ISSUANCE

[In billions of dollars]

	Increase in foreign and international holdings	Total issuance	Foreign and international increase as percent of total issuance
1987:			
I	8.4	295.6	2.85
II	8.3	306.2	2.72
III	−.8	267.9	....
IV	20.6	325.7	6.33
1988:			
I	33.6	289.0	11.64
II	13.3	287.6	4.64
III	−0.1	311.8	....
IV	14.7	294.7	4.99